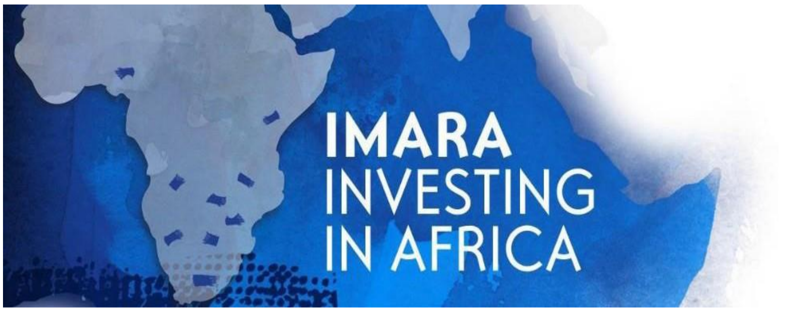

Zimbabwe Investment Notes

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Lockdown ends. Recovery in sight!

In our October Notes we discussed the difficulties of analysing the Zimbabwean economy given the "smoke and mirrors" in the economic data. The official statistics highlight the ZWL economy but with a mixture of the USD informal market creeping into the data. Most analysts would believe that in actual fact, the USD economy would form a significant part of the overall Zimbabwe economy especially now that the use of the USD has been officially sanctioned since June 2020 as a tool to kick start the economy post the first COVID lockdown. The monetary numbers published by the RBZ highlight both ZWL and USD deposits although the latter are accounted for at the official auction rate. The difficulty with these numbers is that with such little trust in Zimbabwe's banking system, most corporates and individuals are reluctant to hold large amounts of USD in the banks for fear that they could not access them or worse, be converted in an instant to ZWL. Recent media reports on house break-ins highlight just how much USD cash certain households are prepared to hold 'under the mattresses'. This cash would not feature in the numbers.

A further 'known unknown' is how much USD cash is sloshing around the system through unrecorded trade. Gold smuggling might be one source of such cash and we have little idea of just how much value of such unrecorded exports might be coming back into the economy in the form of cash or staying outside of it. We also have little idea of how much gold is being produced by informal gold panners but we have to believe that it could be quite a high number given the amount of land that is being mined, legally or illegally. The current price of gold is too attractive to ignore such opportunities. What is for certain is that these individuals will be receiving cash in some form or another from the gold buyers; that cash can then be spent on goods and services in the formal economy, at which point they enter the official statistics.

This 'known unknown' is important to keep an eye on for more esoteric reasons too: the more the economy dollarises the more the Zimbabwean economy becomes linked to the global economy. The trade weighted US dollar, for example, has recently appreciated after a sharp fall, although this series is currently unusually volatile because of Fed actions. The relative changes of the dollar not only affects trade with South Africa and the region - which are both also highly indebted - but also has implications for the liquidity of the foreign currency auction market, the liquidity of the parallel rate market and the stress associated with Zimbabwe's own foreign denominated debt. As the rate of dollarisation grows, government statistics, which are already meaningless because of co-mingled assets at the wrong exchange rate, will become even more meaningless for fiscal management and planning. But what it really means is that the parallel exchange rate is the most important economic variable out there, so we would expect more administrative attempts to try to control it.

Under 'normal' circumstances, reports from companies who publish sales and volume data can give some clues of the level of activity in the informal economy but unfortunately the global COVID pandemic has skewed these numbers as new lockdowns are introduced. This has been affecting the export markets (e.g. Padenga) as well as the local economy as we saw from January this year as a new lockdown was introduced in Zimbabwe. There was a strong recovery recorded over the second half of 2020 as the economy rebounded from the harsh April/May lockdown as the USD economy started to reemerge and ZWL liquidity grew rapidly. Recent quarterly numbers for the last quarter of 2020 highlight this growth.

With a new lockdown announced in early January this year, we would expect that the first quarter numbers for 2021 will highlight renewed weakness in the economy. This however will be short lived in our view. Lockdown measures were eased considerably in March allowing most businesses to reopen again. Further the recent rainy season has been excellent enhancing the prospect of a bumper maize harvest both in Zimbabwe and the region as a whole. If we then add increased gold production -whether formal or informal- to that pot, we should expect to see a very rapid rebound taking pace in the economy from the second quarter of 2021. If Zimbabwe and South Africa can bypass in some way the third wave of the global pandemic and thereby avoid a third lockdown, then the economy should continue to recover throughout 2021 albeit from a low base. Needless to say, if there is a third wave that causes another lockdown, then this rebound could be halted.

Certain sectors will take longer to recover. International tourism is unlikely to rebound until 2022 as Europeans and Americans are urged or forced to stay at home. By that stage we should expect to see international travel rebound quite quickly especially if this particular pandemic has died out. Locked down Europeans will be eager to get out and about again. We should also not underestimate the reduced number of flights to the Southern African region, not helped by fears of the South African variant of COVID in Europe and the USA. Recently for example, Ethiopian Airlines was forced to suspend its flights to the UK in line with that of Emirates. This can only have negative consequences upon supply chains that will impact the availability (and price) of certain spare parts for plant and equipment for example.

A strong rebound in the economy will have a positive impact upon corporate revenues and earnings for those sectors and businesses that are no longer effected by the pandemic. We should start to see evidence of that in the July to September reporting period although some companies may comment on a recovery when announcing their first quarter trading updates.

Official ZWL inflation has dropped since the hyperinflationary levels of 2019/20. The introduction of the foreign exchange auction system has certainly assisted but so too has the relative stability of the parallel exchange rate which we believe has found support following the introduction of the dual currency system in mid-2020. The difference between the two rates though has been widening and now stands at over 40%. We would not be surprised to see the auction rate moving higher thereby narrowing the gap between the two rates. As the tobacco season progresses the auction rate may start to move. Too big a gap is putting exporters, who now have a 40% retention rate on their USD earnings, under growing pressure. That said, for those lucky enough to be able to access funds at the auction rate, the arbitrage opportunities between the two rates offer tempting profits.

In our last Notes, we wrote about our concern over potential USD inflation. We are already witnessing this with fuel prices increasing in USD terms together with soft commodity prices. Internationally there is a growing school of thought that a rapid increase in the money supply in the US will lead to much higher rates of inflation than analysts currently predict. Broad money in the US rose by 26% in 2020 and expectations are that it will rise by at least 12% in 2021 but likely by more. As the pandemic hopefully draws to a close, rapid money growth together with the massive fiscal expansion just announced in the USA should lead to a rapid recovery in the US economy. As the rest of the World re-emerges from the pandemic, it could well trigger a boom in commodity prices. Indeed some international analysts are already writing about the possibility of a ‘commodity super cycle’ in 2021/22. This would have a negative impact upon global inflation, as commodity prices rise. It would be good news for commodity producers such as Zimbabwe and South Africa however whose export prices and hence earnings would rise from current levels. A commodity boom almost always coincides with US dollar weakness but it would put upward pressure on the rand, South Africa being Zimbabwe’s largest trading partner. Such a cocktail would be beneficial for Zimbabwe; it last occurred from mid-2009 to mid-2011.

Our expectations are that USD inflation will continue to rise which itself will put additional pressure on ZWL inflation rates. ZWL inflation has closely tracked ZWL money growth. The RBZ has recently published its December monthly economic review. We note that broad money grew by nearly six times during 2020; stripping out foreign currency deposits from that number local currency deposits rose by 351% in line with inflation which rose by 349% year on year in 2020. Our fear is that monetary growth in 2021 will maintain an upward trajectory which itself will keep ZWL inflation rates high over and above the pressure from external inflation rates.

During the quarter, the Ministry of Finance published details of new foreign denominated loans extended to Zimbabwe by Afreximbank over recent years. These total USD1.4 billion, a large amount for an economy the size of Zimbabwe that only serves to contradict the view that sanctions are hurting the economy. Unlike loans from the IMF or World Bank, these are commercial loans at non-concessionary interest rates and are therefore expensive. Including fees the rate of interest is high at an average of 11% in USD terms. Given that Zimbabwe is already in default to the multi-lateral institutions, one wonders how the country might repay such loans as they are relatively short term. We assume that part of these funds have been used to fund the foreign exchange auction market but may also have been used to import maize following the drought years. The Ministry also published details of the guarantees that the Government has provided CBZ Bank in particular for lending largely to the agricultural sector. A Government guarantee does not appear to be a great way to encourage prudent lending by the banks or indeed an incentive to chase after non-performing loans. Guarantees can however contribute to the accumulation of public debt in the event of default by primary borrowers. The chances are Government is likely to be called upon to underwrite these loans further increasing unbudgeted expenditure.

Government has announced that the Grain Marketing Board (GMB) will be the sole buyer of all maize harvested in 2021. Given the forecasted bumper maize crop, this might require upwards of ZWL60 billion in payments to the maize producers over the coming six months. We fear that the price that the GMB will then sell that maize on to the millers will once again be below the price that they pay the farmers implying a huge monetary loss. This has to be funded somehow and it will fall on Government to produce the ZWL required. We fail to see how this will not result in a substantial boost to ZWL liquidity and hence to inflation.

The ZSE has performed well over the past three months as we had expected. This has been driven almost entirely by domestic investors since foreign investors remain net sellers of the stock market. The stock market remains one of the few places where hard assets can be purchased in meaningful amounts using ZWL rather than USD. Foreign exchange by contrast is hard to access whether on the official auction market or even via the black market.

It is our view that rising ZWL liquidity will continue to find its way onto the ZSE putting upward pressure on share prices. The ZSE performed well in USD terms in 2020 and this has continued in 2021. As we have written in previous Notes, USD valuations on the ZSE in 2019 slumped to levels that were below those of 2008 when hyperinflation was reaching record highs. In short recent USD gains have come from a very low base. Looking at USD valuations today, they remain low by historical standards despite the fact that businesses are in far better shape generally than they were back in 2008/2009. We therefore see no reason why equities will not continue to be one of the better performing ZWL asset classes over the year ahead.

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