Zimbabwe Investment Notes

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Dollarisation: Pulling the Economy out of the Pandemic Slump

In our April Notes we were significantly more upbeat for the economy and the stock market going forwards than for a good while. This was premised on the fact that the country was emerging from the second lockdown with a strong tailwind provided by the rapidly dollarising informal economy. This was also a time when the global economy was bouncing back sharply following the second-wave shutdowns in a number of large economies such as the USA, the UK and Europe assisted by the successful vaccination programmes. This was leading to a steep rise in demand for global commodities whose prices were beginning to rise supported too by a weaker US dollar. This we argued would be positive for commodity producing countries such as South Africa and Zimbabwe.

At the time we thought that first quarter numbers for companies would be weaker compared to a year ago because the second lockdown in January and February 2021 would be compared to a period without a lockdown in 2020. We also thought that the second quarter of 2021 would see a strong year-on-year recovery since Zimbabwe, and the rest of the world, were under a fairly strict lockdown from March 2020 onwards. Since April, we have undertaken a large number of interviews with management teams across a broad spectrum of sectors of the economy to gain a better understanding of current business conditions. To our surprise, for many businesses the first quarter of 2021 was stronger than the first quarter of 2020 despite the lockdown that we experienced in January and February of this year. Obviously for certain operators that were physically closed during the lockdowns such as clothes retailers, restaurants and bars this was not the case as revenues fell sharply. The rest of the economy performed remarkably well however. We attribute this outcome to the increased adoption of the US dollar in both the informal and formal sectors and possibly due to increased domestic spending to reduce the risk of holding large cash balances under mattresses. The second quarter of the year also looks to have been a bumper one as demand remains strong. As we write, we have now entered a third lockdown which will clearly knock the momentum gained since February but hopefully it will be relatively short-lived as was the case for the second lockdown. Moreover businesses have learned to adapt more effectively to these lockdowns this time around with Government appearing to be more flexible.

We had not however anticipated home grown obstacles such as SI 127 which came into effect at the end of May. This statutory instrument was issued with a view to punishing those companies who receive US dollars in the foreign exchange auction at the Government's fixed rate of ZWL85 to USD1 but then go on to price their goods at the parallel market rate. The way the SI was written however, it effectively compelled all businesses to set their prices at the ZWL85 rate thereby allowing consumers to either buy in ZWL or USD based upon that rate. A large number of companies immediately increased their USD prices by over 50% so that the ZWL prices would not alter. Unsurprisingly consumers refused to pay such high USD prices and with little access to ZWL demand for such products collapsed. Fortunately like many such Government regulations that are brought in with no consultation with the private sector, Government back tracked which in effect allows industry to price in both ZWL and USD based upon the supply and demand at those differing price levels. The SI would henceforth be directed exclusively at those businesses which are successful in receiving USD at the auction rate.

Our discussions with management highlighted the difficulties many of them were having in accessing USD through the auction system. The problem is that a successful allocation at auction requires a ZWL deposit with their bank or the RBZ followed by a wait of up to 12 weeks before receiving actual USD. This plays havoc with working capital management as most businesses are unable to stock sufficient inventory to cater for such long delays. Now that there are hefty fines for 'mispricing' products or services through SI 127, it encourages businessmen to simply avoid the auction system and source the USD themselves. The danger then is that the auction will simply be a place for the chosen few to enjoy subsidised foreign exchange and to play the arbitrage game. We have always been sceptical of the auction system recognizing that it is not an auction at all and certainly not a free market for foreign exchange. It will likely remain in place for some time to come, but like the ZWL, it will diminish in importance as time goes by.

Another home grown obstacle thrown into the ring soon after SI 127 was the announcement by the RBZ that any excess ZWL liquidity on bank balance sheets (i.e. deposits that are not lent out) would be compulsory swept by the RBZ and swapped for non-negotiable certificates of deposit (NNCD) which carry a zero interest rate. Should the banks require monies to satisfy customer requirements, they could then borrow that money back from the RBZ at a rate of interest of 30%. For a bank it means paying interest on a retail deposit against which there is no income from lending; it is a direct hit to margins. Quite why this measure was introduced is up for debate; it will clearly tighten ZWL money supply since the main component of broad money supply is deposits held by the commercial banks. NNCD's directly prevent the so-called "money multiplier" from working whereby deposits lent out create more deposits as borrowers bank their newly acquired cash balances. Indeed, some argue that this policy was introduced in anticipation of having to absorb liquidity that would be created by Government to fund the GMB's purchases of maize from the farmers. This may or may not be the case, time will tell. The effect though was that many banks simply stopped lending ZWL to their customers whilst this uncertainty persisted. At the same time, we noticed that some of the banks we deal with on the money market side reduced their deposit rates; in some instances by up to 50%. In an environment where interest rates are already negative in real terms, this was another nail in the coffin of the fixed income market. Our discussions also revealed that banks appeared to be treated differently from one another; in short there was little consistency in the application of the NNCDs directive. Similar to SI 127, some are punished, others are not, some are favoured, others are not. Whilst the issuance of NNCDs has received little media coverage, unlike SI 127, the implications for the banking system are significant. Indeed such pronouncements simply serve to undermine any trust in the banking system and does little for the cause of the ZWL.

The very threat of excess liquidity being swept into NNCDs may explain why recent Treasury Bill auctions have been rather more successful than one might imagine with yields on offer of 19% to 20%. We are informed that the banks may have a renewed appetite for such paper but as yet this has not been confirmed. We are at a mystery as to whom is investing in recent TB issues and it appears to be a closely guarded secret.

The flip side to the lack of trust in the banks and the banking system in general, is that businesses and individuals will try to circumvent the banking sector as best as they can. Covid-19 restrictions on travel would also have the unintended consequence of trapping US dollar savings within the country but outside of the banking system. Rather than deposit savings in the banks which might one day be inaccessible as has often occurred in Zimbabwe these past two decades, people would rather invest those deposits into bricks and mortar for example or other physical assets that can hold their value in real terms. The ZSE springs to mind in addition to that of the property market. For individuals such actions might result in spending excess funds on building materials or buying stands for future development. This is benefitting the hardware stores and building material producers across the country whilst the banks languish. As we have argued before, the ZWL financial system will become a smaller proportion of the economy over time; it is already too small to fund any serious capital investment that the economy might need. (Using the last available RBZ monthly economic bulletin for February 2021, FCA deposits in the formal banking sector were already at 50% of total deposits included in the money supply. Including the informal sector, the portion of USD dollars in the economy would certainly be higher.)

The other issue we raised in our April Notes was our continuing concern about US dollar inflation. At that time many commodity prices had started to rise at an exponential rate, maize futures being one such example. Oil prices have continued to rise and are now close to USD80 per barrel. A part of this has been due to a weaker USD that always lifts commodity prices that are priced in USD. Our fear stems from a rapid increase in broad money growth in the USA which has been rising at the highest levels in well over a decade, coupled with highly expansionary fiscal policies being pursued globally as a result of the pandemic. Consumers in the developed world have pent up savings that they were unable to spend during the persistent lockdowns. They are now back spending again which is driving up demand for goods and services. At this stage central banks don't seem too concerned with rising inflation believing, as many financial analysts do, that this inflation is 'transitory' and in part a result of the base effects caused by the lockdowns. Those who remember the high inflation of the 1970s (a smaller proportion of the financial community these days!) think differently and are keeping a close eye on the broad money growth numbers being recorded in the USA, which tellingly are now published monthly from a weekly frequency; the first time this has happened since the 1970s. Time will tell but our own experience here in Zimbabwe suggests that when it comes to inflation, *"money matters"*.

What cannot be denied is that oil prices continue to rise and this is felt by everyone around the World. Our discussions with businesses here in Zimbabwe reveal that diesel and petrol prices are amongst the highest in the region no doubt as a result of the high rate of tax that the Government imposes on fuel. The same is the case in the UK for example. This puts our industry at a disadvantage when competing regionally. Then again, at least we are now able to fill up our cars and trucks with relative ease now that fuel is sold in USD. ZWL fuel remains in short supply. Rising fuel prices impacts most businesses and especially those whose raw materials are linked in some way to oil as an input. As a result costs in USD terms will be rising which forces companies to pass on those costs to the consumer. This is known as "cost-push" inflation and is something that will affect us all and more so when translated into ZWL prices.

Wages in Zimbabwe have also been rising in USD terms. After the introduction of the ZWL in 2019 and its subsequent rapid devaluation, wage rates in

USD terms plummeted as indeed they had to in our view. Arguably, wages rose too high in USD terms after dollarization in 2009. This only really became apparent from 2012 onwards when the rand started to devalue against the USD making South African wages look lower by comparison; Zimbabwe was simply not productive enough to compete. Wages rose further during the RTGS years of 2016 to 2018 but these of course were not paid in actual US dollars; that was just an illusion. It will be critically important for industry and Government to ensure wages do not rise in USD terms as they did previously as that will simply make industry uncompetitive again. At current levels wages are below those of South Africa thanks to the earlier devaluation of the ZWL against the USD and the recent strength in the rand. We have noticed through our conversations with industrialists that new machinery being installed by various companies at the moment requires far less labour than the old equipment. This is having a highly beneficial impact upon production costs per unit. It is not such good news for employment. The government may ponder why, when labour is so cheap and plentiful, businesses continue to favour capital investment over labour. Taking the three factors of production; land, labour and capital, extremely negative interest rates encourage the overuse of capital. A return to positive interest rates would be in everyone's interest.

As we had forecasted the ZSE has continued to perform well with a further gain of 38% over the second quarter leading to a 130% increase so far this year for the Industrial Index. We wrote in our last Notes that foreign investors have largely sold out of their holdings in Zimbabwe and sadly, we don't expect them to return anytime soon and certainly not before 2023 when the country is due to hold elections. Foreign selling has been comfortably absorbed by domestic purchases over this time period. What has also been interesting has been the performance of the larger blue chip shares as compared with the small and medium sized listed businesses that foreigners had little exposure to. Blue chips have not performed as well no doubt due to foreign selling pressure. The new Top 10 Index has risen by 89% so far this year whilst the All Share has gained 135%. This highlights the importance of holding small and mid-sized companies within a portfolio as we have chosen to do. With foreign selling having largely run its course, blue chips may well start to perform better by comparison. Volumes traded are not that high by historical standards and any buying is tending to push prices higher given that local investors are in no hurry to take profits.

It is always important to cast an eye on USD valuations especially after such strong gains these past twelve to eighteen months. Over a year ago in our various Notes at that time, we highlighted how cheap the stock market was in real terms even by comparison with the valuations of 2008 when Zimbabwe was experiencing hyperinflation. At the end of March 2020 when the world was rapidly locking down, the total value of the Zimbabwe stock exchange was around a mere USD1.6 billion taking a parallel market exchange rate of ZWL38 to USD1 at that time. Delta being the largest listed counter had a value of just over USD200 million. At its peak in 2013 it reached nearly USD2 billion. At an exchange rate of ZWL130 to USD1, today's market value is just over USD700 million which, for a business that is recovering from the pandemic and with spare capacity on hand, is not expensive by any means; and that despite a three-fold gain in USD terms over the past fifteen months.

There is a school of thought that might question whether in fact the parallel rate of ZWL130 is the correct rate to use in such valuations. We know that the RBZ has control over the foreign exchange auction rate; what is not known is how much control the authorities might have over the parallel rate. A year ago, the Old Mutual traded on the ZSE and this gave an implied exchange rate that could be calculated daily. This was a true market rate as the rate could be influenced by bringing in shares to the country from South Africa and vice versa thereby impacting upon the supply and demand of Old Mutual shares locally. The Government felt that the implied rate was driving the parallel rate and hence they forced the suspension of Old Mutual shares on the ZSE on 23rd June 2020. The parallel rate can to a certain extent be 'controlled' through regulatory means; tightening the ZWL money supply, introducing SI 127, or coercion of corporates by the RBZ to not use the parallel market for large transactions. The parallel market is best thought of as having two components; the kerb or street market where currency is exchanged and which is totally unregulated, and sales made (legally) by corporates in USD to satisfy USD funding and investment requirements. It may well be the latter is setting the parallel rate if it is a larger and deeper market. If ZWL130 is the correct exchange rate now, then corporates should broadly be able to derive all the US dollars they need to fund their operations by pricing their products at this level. Our company discussions suggest many (non-mining) corporates are generally able to source their *minimum* foreign exchange needs at ZWL130 ……… for the time being.

For businesses that cannot sell their services for USD, they may have no choice but to seek funds elsewhere. This may not be as easy as it once was; the RBZ's Financial Intelligence Unit is actively watching for suspicious transactions within the banking system. The street rate is controlled through the lack of physical cash and mobile money is restrained by the small amounts of transactions permissible. If the true rate was somewhere near say ZWL160 to USD1, then the valuation of Delta would be just over USD500 million. Whether we take 160 or 130 as an exchange rate, Delta is hardly expensive but clearly the easy money has been made. Supporting equities going forwards will be upbeat trading statements being released by industry, especially once the lockdowns are behind us.

We were delighted that the RBZ disallowed the Seed Co merger with Seed Co International. As a result of that order Seed Co was relisted on the ZSE in June allowing its true valuation to be reflected on the market. Currently that value stands at USD100 million using ZWL130. Meanwhile the market value of Seed Co International itself languishes around USD95 million with little trade taking place on either the Botswana Stock Exchange or the VFEX. At least now domestic pension funds can continue to purchase one of Zimbabwe's more successful agricultural concerns. We have to question how shareholders were asked to vote for the merger of Seed Co and Seed Co International when all conditions precedent for such a transaction had not been met, that being the approval from the authorities.

We were disappointed to see that Padenga has just chosen to delist from the ZSE and simultaneously relist on the VFEX in order to gain the tax breaks associated with their new mine coming on-stream. We voted against that move. Domestic investors will no longer be able to buy into the company unless they have free funds available. Pension funds largely have ZWL so will not be able to participate. We like Padenga and are excited by their new gold operations and in our opinion the shares are significantly undervalued so it is a great pity that we will not be able to buy the shares in any meaningful way going forwards. It would have been better for the government to give all listed mining companies the same tax break to encourage domestic listings on the ZSE and to enable local pension funds the ability to hedge against devaluation and inflation by investing in them. Cannibalisation of the ZSE's exporters might now be inevitable which would be negative for local ZWL investors.

Finally, we have another "unknown known" occurring over the coming months and perhaps just in time for the election. The IMF will be issuing a total of USD650 billion worth of SDRs to be shared amongst its members as 'Global Reserve Funds'. By all accounts, Zimbabwe's share could amount to just over USD1 billion which is highly significant if the economy as measured by GDP is an estimated USD16 billion. These SDRs could be issued by September this year. Further, as we understand it, there are few conditions attached as to how this money should be spent. The only condition appears to be that there should be transparency as to how the funds are used by any participating member. Some countries may just use the funds to bolster their foreign exchange reserves. Time will tell how Zimbabwe chooses to allocate the monies but given its size to the economy, we hope the funds are allocated wisely for the greater good of Zimbabwe and its people.

We continue to hope and pray that the pandemic will peter out in 2021 as vaccination programmes accelerate and herd immunity increases. It has been heartening to see the optimism currently being seen in the US, UK and Europe as those economies reopen and try to return to some kind of normality. We see no reason why we should not all feel more optimistic as the lockdowns in our own region disappear allowing us all to do what we want, where we want, with whom we want and when we want!

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