Macroeconomic variables vs market performance

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There are several factors that influence share prices and the level of returns for investors. The key factors are: (1) demand and supply; (2) economic variables [i.e. GDP, inflation, interest rates and exchange rate]; (3) corporate actions, and (4) psychological or market cycle-related factors. In today's article, we will focus on the economic variables.

The value of the company, its return on investment and share price reflects the perception of its earnings performance and growth. If the stock market detects something about a company that may harm its earnings flow, its share price falls. If the stock exchange hears good news about the company — its earnings, new innovations, expansion to other geographical locations, etc. that have future earnings growth potential — its share price in most cases will increase.

Share prices change because sellers and buyers are constantly reviewing companies' news and especially its earnings prospects.

Therefore, in this context, one may claim, there are two factors that determine a change in share prices - future expectations of earnings and the price to earnings multiples, as we have learnt in a previous article. Both factors depend on an evaluation from buyers and sellers as they learn more about and understand the listed companies.

Apart from fundamental company performance-related factors, investors are also looking at other market information, including economic news (such as economic growth, inflation, changes in exchange rates, change in interest rates, etc.) and also political events that can cause share prices to rise or fall. In the short term, the share price is also affected by intangible factors such as hype and word-of-mouth.

Share prices performance on companies listed in the DSE, like other stock markets, are also influenced by the happenings of other markets and economies (though it may not be as direct for the case of the DSE).

If there is a substantial fall in other major markets prices and indices, Tanzanian share prices are likely to be under pressure as well, mainly because of foreign investors participation in our market.

Foreign strategic investors own a large part of companies listed in our stock market, and foreign portfolio investors commands almost two-third of our periodical trading activities.

Stock market performance largely depend on the state of the economy, economic activities, future outlook and quality of decisions made. Economic policies, among others affect economic variables which are then extended into companies' earnings and prospects.

Specifically, economic variables that affect the stock markets are:

- Interest rates
- Inflation or the rate of change in consumer prices
- Rate of economic growth (measured by Gross Domestic product - GDP)
- Exchange rates
- The health of other key economic sectors.

Interest rates and inflation

Interest rates affect companies' earnings directly because their debt repayment costs rise and fall depending on the interest rate changes.

Interest rates determine how much it costs the company borrows or what an investor should expect on their investments.

A rise in interest rates increases the attractiveness of fixed interest investments (such as bonds) relative to shares.

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High interest rates also increase a company's borrowing cost. It also means taking money directly from profit to pay the company's bankers. Rising interest rates also affect the level of economic activity and consumer spending.

Alterations to interest rates is one of the economic monetary policy instruments used by Central Banks. Central Banks may lift interest rates to choke off any stirring of inflation, as a result of bubbling economic activity.

During a period of tight liquidity, an interest rate rise increases production costs. Conversely, interest rates fall when there is ample liquidity.

People have more purchasing power, which is positive for business expansion and share investment.

During these times, interest rates are used as tools for mopping up excessive liquidity.

Inflation simply refers to how much the prices of the goods and services that you buy go up by each year. It is usually written as a percentage. One of the reasons that people invest in the share market is to try and beat inflation.

The stock market dislikes inflation, as inflation pushes up costs for companies quicker than it can pass them on to customers, adversely affecting earnings. Conversely, when a central bank believes that economic growth needs to be stimulated or an economic decline reversed, it will cut interest rates.

Historically, low inflation has had a strong inverse correlation with valuations (low inflation drives high multiples, and high inflation drives low multiples). Deflation, on the other hand, is generally bad for shares because it signifies a loss in pricing power for companies.

The exchange rate

A company that exports or imports products or services, or has receipts or payments in other currencies, is affected by the exchange rate between the local currency and foreign currencies. The most important of these currency crosses is the rate of the local currency to the US dollar.

Higher local currency in relation to the US$ can be good for certain sectors of the economy, making both exports and local import-replacement industries more competitive. It's particularly good for local producers and businesses who sell their products in $ but take their profits and report their earnings in local currency.

Apart from an indirect impact of foreign exchange to investors in securities (shares and bonds)—investors, especially foreign investors are also directly affected by the movement in the exchange rate. The fall of the local currency against the United States dollar have negative impact in market valuations, size of the market and indices performance but also in trading activities.

The GDP

Gross Domestic Product (GDP) is the value of all goods and services produced in the economy. When the GDP decreases, the economy contracts - and companies' earnings fall. When the GDP increases, the economy expands, and companies' earnings rises Therefore, any prospects of positive economic (GDP) outlook attract investors in the market... But, the opposite is also true: prospects of negative outlook in the economic activities reduce investment in the market.

Health of the key economies

Foreign (strategic and portfolio) investors accounts for more than two-third of ownership and trading activities in our local market.

The recent and ongoing global case of the Covid-19 pandemic has negatively impacted the equity segment of the market - mainly due to other emerging priorities, immediate cash obligations by fund managers, and the focus on less risky investments.

In the short term, when there is bad economic news, stock markets come under pressure - and some of the immediate results are a decline in liquidity, prices, indices and market size.

Unless there are rescue policies and packages, it takes time before good news ensues.

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