FULLY INVESTED

July 2023

Quarterly Investment Commentary

Market Overview

The second quarter remained dominated by several key themes including central bank activity, the health of the global economy and the pace of China's recovery following the re-opening of the economy in January. On the local front, investors continued to track major global events with heightened levels of load-shedding and political turmoil creating further idiosyncratic headwinds.

Global markets continued to see upward momentum over the period (MSCI World Index: +7%), however, this was mainly driven by a robust performance out of the US (S&P 500: +8.7%). Emerging markets (MSCI Emerging Markets Index: +1%) contributed very little to the positive performance with China being one of the biggest laggards (MSCI China: -9.8%). In terms of monetary policy activity, central bankers continued to reinforce the notion that policy rates still need to be "sufficiently restrictive" and kept elevated for as long as necessary. Recently, the Bank of England (BoE) raised rates more than expected in June, while the US Federal Reserve paused its cycle but signalled more hikes ahead. The European Central Bank (ECB) remained hawkish and noted that a July hike was 'very likely'. This rhetoric has continued to fuel fears for a contraction in global growth.

US markets delivered a solid performance over the quarter, which was mainly driven by the tech sector (NASDAQ Index: +15.4%), particularly counters with upbeat AI prospects. On aggregate, economic data out of the region continued to surprise to the upside (most recently, US GDP growth came in at 2% for 1Q23 compared to expectations for 1.4%), which contributed to the positive market performance. This also showed that the world's largest economy is holding up relatively well compared to initial expectations. While the US Federal Reserve left rates unchanged at the June meeting (this was the first pause after ten consecutive hikes that lifted US borrowing costs to the highest level since September 2007), US Fed Chair, Jerome Powell, stated that more restrictions are needed to tame inflation with at least two more rate hikes expected this year, with the probability of a 25bp hike at the July meeting recently increasing to 81.8% from 76.9%, according to CME's FedWatch Tool. Powell also noted that the US economy is quite resilient and a recession, although possible, is not the most likely case. The target rate was left unchanged at 5% to 5.25% in June but may go to 5.6% by year-end if the economy and inflation do not slow down further.

On the other hand, economic data out of Europe was generally lacklustre, contributing to the lagging performance in the Euro Stoxx 600 (+2.7%). Core inflation in the region remains elevated and is expected to remain sticky according to comments from European Central Bank (ECB) President, Christine Lagarde. Policymakers see little reason for a pause in rate hikes at this stage, as the central bank needs to bring interest rates into sufficiently restrictive territory to lock in policy tightening, despite signs of a slowdown in the Euro Area. In June, the ECB raised interest rates by another 25bps and maintained the view that more ground needs to be covered going forward.

China remained under pressure and delivered an unfavourable performance compared to emerging market equities. This was due to ongoing geopolitical tensions and concerns over the pace of the economic recovery as generally softer economic data, released towards the latter part of the quarter, bolstered concerns over whether the "re-opening rally" had run out of steam. As a result, the People's Bank of China (PBoC) cut two key lending rates at its June "fixing", as authorities sought to prop up growth. While investors saw this as a move in the right direction, some market participants were hoping for larger cuts.

The local market ended the quarter almost flat (All Share Index: +0.7%) but was down 5% in US dollar terms as the general risk-off mood globally was amplified by SA-specific risks (including severe levels of load-shedding, the subsequent risk of a grid collapse, as well as geopolitical angst). However, a strong recovery was seen over the first half of June as the heightened risk environment began to subside. This led to a significant improvement in the rand, with the local unit breaking to below the critical R19/$ level. Meanwhile, headline inflation came in at 6.3% y/y in May (April: 6.8%) which was better than expected and at its lowest reading in a year. This reflects the higher base created last year, which should support lower inflation going forward and is now closer to the upper limit of the South African Reserve Bank's (SARB) target range of 3% to 6%.

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Economic Data Review

The US Federal Reserve paused rate hikes but remains hawkish with Chairperson, Jerome Powell, guiding for two more hikes

Flash estimates showed that the S&P Global Composite PMI for the US decreased to 53 in June 2023, from a final reading of 54.3 a month before. This signalled the slowest upturn in private sector output since March, as factory production fell at the steepest rate since January and service sector activity expansion cooled from May's 13-month high. Retail sales for May increased 1.6% y/y, higher than expectations for growth of 1%. In April, the trade deficit widened to $74.6 billion, compared to forecasts of $75.2 billion, as exports declined, and imports increased. The unemployment rate in May increased to 3.7%, above market expectations of 3.5%. Annual inflation declined to 4%, the lowest since March 2021, and below market forecasts. The Fed kept rates unchanged, in line with expectations, as nearly all FOMC participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year. The Fed will continue to make decisions on a meeting-by -meeting basis, based on the totality of incoming data and their implications for the outlook for economic activity and inflation, as well as the balance of risks. At the same time, inflation pressures continue to run high, and the process of getting inflation back down has a long way to go and will take time for the full effects of monetary restraint to be realised.

The ECB remains steadfast in its battle against inflation as the core reading remains sticky

On a preliminary basis, the HCOB Eurozone Composite PMI decreased to 50.3 in June, compared to 52.8 a month before. This was below expectations of 52.5. Retail sales in April were down 2.6% y/y, compared to forecasts of a 3% decline. A trade deficit of €11.7 billion was recorded in April, compared to forecasts of a $21.5 billion surplus, as imports tumbled 11.9% and exports declined 3.6%. The unemployment rate edged down to 6.5%, in line with market estimates. Consumer price inflation for May came in at 6.1%, in line with consensus

Annual inflation declined to 4%, the lowest since March 2021, and below market forecasts.

Initial reports showed that the S&P Global/CIPS UK Composite PMI fell to 52.8 in May

expectations. The ECB raised its key interest rates by 25bps during its June meeting, as expected. ECB President, Christine Lagarde, said that inflation in the Euro Area is too high and is set to remain so for too long. Wage growth is now pressuring inflation, which is entering a second stage and is set to linger for some time. As a result, the ECB needs to bring interest rates into sufficiently restrictive territory to lock in policy tightening. Additionally, Lagarde stated that the ECB had more ground to cover and would likely continue raising rates in July.

The BoE raised rates once again, with further tightening expected

Initial reports showed that the S&P Global/CIPS UK Composite PMI fell to 52.8 in May (forecast: 53.6). Retail sales decreased 2.1% y/y in May, compared to forecasts of a 2.6% drop. In April, the trade deficit narrowed to £1.52 billion as exports increased 1.3% and imports fell 0.6%. Slightly below market expectations, the unemployment rate came in at 3.8%. Annual inflation in the UK held steady at 8.7% in May, still exceeding market expectations. The BoE raised its policy interest rate by 50bps in June 2023 (ahead of expectations), marking the thirteenth consecutive rate increase. Policymakers have also pledged to deliver further rate hikes if the ongoing inflationary pressures persist. The BoE initiated rate hikes nearly a year and a half ago, making it the first major central bank to take such action and resulting in the fastest policy tightening in over 30 years.

The PBoC cut lending rates to stimulate growth following the release of softer economic data

China's composite PMI rose to 55.6 in May, from 53.6 a month before. It was the fifth straight month of growth in private sector activity and the steepest pace since December 2020. Output rose faster across both the manufacturing and service sectors, with the latter seeing a quicker rate of rise. Retail sales expanded 12.7% y/y in May, missing market expectations. The country's trade surplus dropped to $65.81 billion in May (forecast: $68 billion), compared to $78.4 billion over the same period a year ago, as exports fell more than imports, amid persistent weak global demand. The surveyed urban unemployment stood at 5.2% in May. China's annual inflation rate edged up to 0.2% in May, below market consensus of 0.3%. The PBoC slashed two key lending rates for the first time since August 2022 at the June fixing, as authorities seek to prop up growth. The one-year loan prime rate (LPR), which is the medium-term lending facility used for corporate and household loans, was lowered by 10bps to 3.55%; while the five-year rate, a reference for mortgages, was trimmed by the same margin to 4.2%, in line with market expectations. Meantime, several global investment banks, most recently Goldman Sachs, cut their 2023 GDP growth forecasts for China following weak economic data for May. The economy is also coping with a steady disinflationary trend, amid feeble consumer and business spending.

Inflation decreased ahead of expectations in Japan, however, policymakers remain cautious

Early estimates showed that the Jibun Bank Composite PMI reading in June fell to 52.3. This was the sixth straight month of growth in private sector activity but the softest pace since February amid lingering global economic uncertainty, as the services economy grew at a softer pace while the manufacturing sector saw a fresh contraction. Retail sales for May increased 5.7% y/y, exceeding expectations for growth of 5.4%. Japan's trade deficit fell to ¥1.37 trillion in May, compared to ¥2.37 trillion in the same period a year ago. This was slightly higher than the estimated gap of ¥1.33 trillion. The unemployment rate dropped to 2.6%, below market consensus of 2.7%. Annual inflation unexpectedly declined to 3.2% in May, coming in lower than market forecasts of 4.1%. The Bank of Japan (BoJ) kept its key short-term interest rate unchanged, in line with market expectations. While mentioning that inflation in the country would slow later this year, policymakers added they would patiently continue with monetary easing and respond to uncertainties faced by the economy and the dynamics of prices as well as financial conditions.

In South Africa, inflation fell to a 13-month low with abating idiosyncratic risks supporting sentiment

In May 2023, the SACCI business confidence index dropped to a nine-month low of 106.9 (April: 107.1), while the leading business cycle indicator fell 1% from a month earlier in April 2023. Sentiment in South Africa was impacted by lower trade volumes, fewer inward tourists, as well as a weaker rand compared to other major trade and investment currencies. The composite PMI in May decreased to 47.9 (April: 49.6), signalling a further downturn in private sector activity. Manufacturing PMI fell to 49.2, from 49.8 a month before. Retail sales in April contracted 1.6% y/y, marking the fifth consecutive decline in retail activity. This was slightly worse than market expectations of a 1.4% decrease. SA recorded a trade surplus of R3.5 billion, below expectations of R4.9 billion, as exports tumbled 14.5%. The value of recorded building plans passed in SA's larger municipalities rose 3.7% y/y, following a downwardly revised slump of 17.4% a month before. Mining production recovered 2.3% y/y in April, better than the forecasted increase of 0.9%. This followed a downwardly revised drop of 2.2% in the previous month. Manufacturing production increased 3.4%, signalling the first annual gain in six months as extreme load-shedding-related pressures were eased. This was better than expectations (+2.5%).

Consumer price inflation (CPI) dropped to a 13-month low of 6.3% in May, compared to forecasts of 6.5%. This was mainly due to the cost of food and non-alcoholic beverages increasing at a slower pace. Nevertheless, SA inflation remains above the Reserve Bank's target range of between 3% and 6%. As expected, core inflation edged lower to 5.2%. Also, in line with expectations, producer price inflation (PPI) slowed to 7.3% in May, compared to 8.6% a month before.
Due to the significant depreciation of the rand and the mounting pressures of inflation, the SARB implemented another 50bps rate hike during its May meeting, bringing the benchmark interest rate to 8.25%. This was the tenth consecutive rate hike since policy normalisation began in November 2021 and borrowing costs are at their highest levels since May 2009. Headline inflation for 2023 is expected at around 6.2% (previous guidance: 6%).

Elevated inflation and tighter financial conditions should weigh on household consumption expenditure growth.

Outlook

Local

- Global growth prospects have become less pessimistic. The World Bank's forecast for global growth this year lifted to 2.1% in June, versus 1.7% in January, but a slowdown from 6.0% in 2021 and 3.1% in 2022 is still a primary feature of the outlook. In addition, while global inflation has been slowing, it remains elevated and there are signs of reflation in emerging markets where exchange rate and wage pressures have edged higher.

- Exchange rate pressures are also slowing the deceleration process in South Africa, worsening imported inflation, and compounding the passthrough of marginal input cost pressures from intensified load-shedding. We predict headline inflation to average 6.2% this year, slowing to around 5% in 2025. Our anticipation that local inflation will remain above target over the medium term mainly reflects global trade tensions and frictions related to climate change and should result in interest rates remaining above pre-pandemic levels over the forecast horizon.

- The repo rate should lift to 8.5% at the July MPC meeting, ushering in the end of the current hiking cycle. A halt to the hiking cycle would be supported by an improvement in risk sentiment and the rand since the previous MPC meeting. In addition, a continued moderation in inflation outcomes, with a likely reversion to the inflation target band in June, will be supportive. Upside risks would stem from further rand weakness ahead of the BRICS summit, as well as a resumption of the Fed hiking cycle.

- Elevated inflation and tighter financial conditions should weigh on household consumption expenditure growth. Furthermore, net trade benefits will be curtailed by logistical inefficiencies. With mainly the ongoing replacement cycle and investments in energy supply driving growth this year, we anticipate no expansion in the economy and GDP growth should average -0.1%. Risks to this view are balanced, with upside risk driven by less intense load-shedding and more positive 1Q23 growth, which indicated that some sectors of the economy may be less reliant on electricity from the grid. Downside risk would be driven by more pronounced cost of living pressures.

- Growth is predicted to improve to 1.5% on average over the period to 2025, supported by higher global growth and easing energy constraints.

Global

- Our primary concern going forward is whether the resilience of company earnings can be extrapolated into the future. We believe that this may prove difficult as fiscal and monetary policy, particularly in the US, will likely be on a restrictive path. In particular, the lagged effect of tightening monetary policy actions will likely begin to filter through to changes in both corporate and consumer spending patterns.

- Higher borrowing costs for both businesses and consumers will likely suppress economic activity, particularly in discretionary related areas, as economic agents look to rein in expenditure to tighten their balance sheets and income statements.

- At the moment, households will likely continue utilising various credit instruments, particularly credit card debt, which is currently at all-time highs, to prop up short-term expenditure prospects.

- Moreover, the reactivation of over $1.6 trillion of student debt in October may well present a headwind to future earnings prospects.

- Nevertheless, if liquidity remains plentiful, this may prevent price discovery from emerging in the short-term. Similarly, it is worth noting that the Fed has articulated that they need to tighten financial conditions, but the reverse has indeed occurred.

- Against this backdrop, we believe that the loosening of financial conditions in recent months will likely embolden the Fed to tighten interest rates further as we progress into the second half of the year, as this will likely be needed to bring core inflation levels down to more sustainable levels. Similar sentiments are certainly shared by the Bank of England with their surprise 50bps hike, as well as the Eurozone Central Bank, which recently lifted the refinancing rate by 25bps.

- The treasury general account will likely be replenished amid the debt ceiling being lifted with much higher interest rates increasing the US government's debt servicing profile. This may also have net negative impact on liquidity dynamics if the drawdown in the reverse repurchase programme does not offset this occurrence.

- In emerging markets, it is certainly encouraging to see the People's Bank of China ease monetary policy conditions further by slashing several different interest rates over the month. However, weakness in coincident to lagging economic data, particularly sluggish consumption expenditure amid pre-payment of mortgages by locals, highlights a potential confidence issue in the broader economy. With low levels of inflation and notable excess savings combined with attractive valuation multiples, we are of the belief that selected opportunities remain in the Chinese economy and will be on the lookout for more palatable policy responses from fiscal authorities.

- Once peak hawkishness of the Fed has been sufficiently priced in by market participants, labour market weakness emerges and inflation is firmly on a downward trajectory, we will be looking to take a more explicit position on the long end of the curve. This will be to reflect a deterioration in growth dynamics that will begin to overshadow inflation fears. For now, T-bills remain attractive with a higher-yield offering compared to most sovereign bond curves without taking on too much duration risk.

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