OVERBERG MARKET REPORT

Tuesday 23rd February 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- The million-dollar question is whether US inflation will rise temporarily above 2% or whether the unprecedented levels of monetary and fiscal stimulus will open the inflationary Pandora's Box and cause an enduring and out of control acceleration. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Inflation ticked up slightly in January to 3.2% from 3.1% in December, slightly below analyst expectations. The latest reading is within the 3% to 6% target range of the South African Reserve Bank (SARB) and well below the midpoint of 4.5%. The annual inflation rate was largely driven by higher prices for food and non-alcoholic beverages (+5.4%), housing and utilities (+2.6%) as well as miscellaneous goods and services (+6.5%). Higher food and international oil prices are expected to put pressure on consumer prices over the short term, but consensus is for inflation to remain contained in the short to medium term. Given low pass-through, risks to inflation from currency depreciation are also expected to stay muted. However, additional exchange rate pressures could result from fiscal risks. While there are no demand side pressures evident, electricity and other administered prices remain a concern. The SARB monetary policy committee, in its January meeting, forecast inflation for 2021 to be at 4.0% (up from 3.9%) and 4.5% (up from 4.4%) for 2022. Given the muted inflation outlook, the SARB has monetary policy space to maintain current low interest rates at least until the end of the year.

- Real retail sales dropped by 1.3% year-on-year in December, with most of the decline attributed to the 'other' retailer category (which includes jewellery, recreational and entertainment goods as well as online sales). For the full year, retail sales dropped by 6.9% in 2020-the worst overall annual contraction on record and the only year of contraction apart from 2009, during the height of the global financial crisis. The annual decline in retail sales further underscores the pressure on households as consumers saw their incomes shrink, lost their jobs, or became more cautious about making large purchases. In contrast, on a quarterly basis, growth in the fourth quarter was positive as sales volumes improved by 2.8% on a seasonally adjusted basis. Retail sales growth is expected to improve further in 2021, reflecting extremely low base effects formed in 2020 and supported by low inflation and low interest rates. Nevertheless, the longer-term outlook for the industry remains negative, weighed on by rising unemployment and generally low consumer sentiment.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- Composite Leading Business Cycle Indicator, due Tuesday 23 February. The South Africa Reserve Bank's (SARB) composite leading business cycle indicator is expected to have increased 1.6% month-on-month in December 2020. This an improvement from the 1% month-on-month increase recorded in November, but slower than the 3.1% recorded in October indicating a slowdown in momentum possibly resulting from renewed lockdown measures during December.

- Unemployment Rate, due Tuesday 23 February. Employment growth is expected to have improved during the last quarter of 2020 as a result of economic activity returning to normal under lockdown level 1 and level 3 in addition to the temporary seasonal employment growth which is usually present during the festive season. Despite these improvements, the consensus forecast is for the unemployment rate to have increased from 30.8% to 32% in the fourth quarter of 2020 due to the large number of previously discouraged work seekers who have re-entered the labour market.

- National Budget, due Wednesday 24 February. Finance Minister Tito Mboweni will table parliament's 2021 national budget following a difficult economic year caused by the Covid-19 pandemic, which negatively impacted both the local and global economy. The budget deficit is expected to have narrowed to 12.9% of Gross Domestic Product (GDP) compared to 15.9% projected in the Medium-Term Budget in October with tax revenue expected to exceed the Medium-Term estimate by R100 billion while government expenditure is forecast to end the current fiscal year slightly lower than Medium-Term estimates.

- Producer Price Index, due Thursday 25 February. Producer inflation is expected to have increased marginally in January because of rising oil prices. The consensus forecast is for PPI to have edged up to 3.3% year-on-year and 0.1% month-on-month in January from 3% and 0.2% respectively in December.

- Private Sector Credit Extension, due Friday 26 February. The private sector credit extension (PSCE) growth numbers are expected to have continued improving marginally in January to

3.7% year-on-year from 3.6% in December 2020. This improvement is expected on the back of an increase in both households' and companies' demand for credit, driven mainly by low interest rates. Nevertheless, credit conditions remain weak, with the pace of recovery in credit growth constrained by weak confidence and an uncertain economic outlook.

- Balance of Trade, due Friday 26 February. The trade surplus is expected to have narrowed to R22.8 billion in January, down from the R32 billion recorded in December 2020. This will mark the ninth consecutive month that South Africa records a trade surplus. The surplus is expected due to robust terms of trade which have been maintained throughout January with the expected narrowing from December's surplus resulting from a decline in seasonal trends.

- Total New Vehicle Sales, due Monday 1 March. Trading conditions in the new vehicle market are expected to have remained challenging during February 2021 because of slow demand when compared to pre-Covid levels, the volatile exchange rate and the negative impact of rising fuel and electricity prices on household expenditure.

NORTH AMERICA

Contributed by Nick Downing

- Minutes from the Federal Reserve's monetary policy meeting on 26-27th January reveal a growing confidence in the economic recovery. However, despite the strong recovery, policy makers regarded inflationary risk as still being tilted to the downside. The Federal Open Market Committee (FOMC) expects inflation to exceed 2% during the second quarter but is doubtful that higher inflation will endure. According to the minutes, "It was important to abstract from temporary factors affecting inflation, such as low past levels of prices dropping out of measures of annual price changes or relative price increases in some sectors brought about by supply constraints or disruptions, in judging whether inflation was on track to moderately exceed 2 per cent for some time." The Fed expects it will be a considerable time before this sustained state of inflation overshoot materialises or for the economy to attain full employment. The Fed is committed to maintaining its current zero interest rate policy and $120 billion per month asset purchase programme until these long-term conditions are met.

- Retail sales surged in January helped by the pandemic relief programme enacted at the end of December, which included once-off stimulus cheques and enhanced unemployment payments. Retail sales increased by 5.3% month-on-month. It was the first increase in four months and the largest since last June, exceeding the 1.1% consensus forecast by a substantial margin. On a year-on-year basis, retail sales grew by 7.4%. With consumer spending comprising around two-thirds of US GDP, the data will prompt economists to raise their first quarter GDP forecasts. The GDPNow Model formulated by the Federal Reserve

Bank of Atlanta, increased its annualised GDP growth forecast for the quarter from a previous 4.5% to 9.5%. Retail sales growth was broad-based. Even food services, which include bars and restaurants, enjoyed a 6.9% increase on the month. Online sales grew by 11%. Although a pullback in retail sales is likely in February as the stimulus effect of once-off $600 cheques fades, President Biden is forging ahead with a third stimulus package which proposes even higher once-off cheques of $1400. Meanwhile, industrial production also gained in January, growing on a month-on-month basis for a fourth straight month, by 0.9%, although remained 1.8% below its level a year ago. Nonetheless, the industrial production reading was stronger than expected. The economic recovery is picking up momentum and likely to accelerate amid continued easing in social restrictions, a rising vaccination count, low interest rates and the prospect of further fiscal relief.

- The IHS Markit composite purchasing managers' index (PMI), a monthly survey measuring conditions across both manufacturing and service sectors of the economy, increased in February from 58.7 to 59.8 its highest level in almost six years. While the manufacturing PMI slipped from 59.2 to 58.5 it remained well above the key 50-level which demarcates growth from contraction. The standout was the services PMI, which unexpectedly increased from 58.3 to 58.9 amid easing restrictions on businesses and individuals. According to IHS Markit chief business economist Chris Williamson, "The data add to signs that the economy is enjoying a strong opening quarter to 2021, buoyed by additional stimulus and the partial reopening of the economy." He added that "Assuming vaccine rollouts can boost service-sector growth alongside a sustained strong manufacturing sector, the second half of the year should see a robust recovery take hold."

- The residential property market is booming, helped by record low mortgage interest rates and growing demand for larger properties as homeowners are increasingly able to work from home. The number of home sales increased in 2020 to their highest level since 2006. The trend continued in January with existing home sales increasing by 0.6% month-on-month and by 23.7% year-on-year. Demand is so strong and inventories of homes for sales so depleted that in some areas, buyers are joining waiting lists. The inventory of homes for sale has reduced to just 1.9 months' supply at the current sales rate. Home prices are surging as a result. According to the National Association of Realtors, the median existing home price increased in January by 14.1% on the year. As a result of record low interest rates, total outstanding mortgages increased in the fourth quarter of 2020 by $182 billion the largest quarterly gain since 2007. However, rising inflation expectations and a rapid pick-up in Treasury bond yields is prompting a spike in the average 30-year mortgage rate, which jumped in the past week from 2.80% to 2.99%. Provided mortgage lending rates rise gradually, the outlook for the housing market remains positive, especially favouring the home construction industry and benefitting furniture, electronics and home improvement retail sectors. Rising home prices also create a strong multiplier effect by lifting net household wealth and the propensity to spend.

CHINA

Contributed by Nick Downing

- Beijing is determined that China becomes the first major economy to adopt a central bank digital currency. The e-yuan backed by the People's Bank of China will begin localised trials this year ahead of expected adoption at the end of 2022. The digital currency will be downloaded onto e-wallets either online or from ATMs. The initiative is part of China's drive to enhance the yuan's global influence, while at the same time boosting the state's surveillance capabilities, especially useful in countering money laundering. The central bank digital currency programme is likely being accelerated to counteract the growing acceptance of cryptocurrencies and the rising influence of fintech companies. The e-yuan may have lasting repercussions for the business models of Alipay and WeChat Pay, China's leading online payment platforms belonging to Alibaba and Tencent, which in recent weeks have been placed under increasingly restrictive regulations.

JAPAN

Contributed by Carel la Cock

- The Jibun Bank Flash Composite PMI for February showed that the private sector in Japan experienced another deterioration follow the contraction in January. The composite output index improved marginally from 47.1 in January to 47.6 in February, but still below the key 50-level. Manufacturing output improved from a contraction in January to an expansion in February but was partly offset by lower business activity in the services sector caused by fewer new orders as domestic demand waned. Despite the weaker demand, employers in the services sector increased their headcount for the first time in a year while expectations for the next twelve months improved from the reading in January, marking the highest reading in three months. The manufacturing sector saw an expansion in both output and new orders in February at the fastest rate in over two years and new export orders also recorded growth, expanding for the first time in four months. Optimism amongst manufacturers improved from the month before continuing the trend which started in May last year. Overall, there is positive sentiment that the end of the pandemic will restore domestic and global demand, further strengthen manufacturing and see a return to normality for the services sector.

EUROPE

Contributed by Carel la Cock

- The IHS Markit Flash Eurozone PMI has revealed the effect of the latest lockdown measures on the European private sector. While lockdown measures have severely impacted the services industries, manufacturing has gone from strength to strength, accelerating from the expansion recorded in January. The Manufacturing PMI Output Index rose from 54.6 in January to 57.6 in February, a four-month high, while the Manufacturing PMI stood at 57.7 compared to 54.8 in January, marking a 36-month high. In contrast the Services PMI Activity Index slumped further to 44.7 in February from 45.4 the month before, the worst reading in three months. Services were particularly hard hit in Germany and France which saw restrictions to stem the second wave of covid-19 infections impact significantly on the sector. However, analysts are quick to point out that the PMI numbers are on average not as low as during the first wave, indicating that the second wave of infections will have only a mild impact on economic activity this quarter. Chris Williamson, Chief Economist at IHS Markit notes: “Ongoing COVID-19 lockdown measures dealt a further blow to the eurozone’s service sector in February, adding to the likelihood of GDP falling again in the first quarter. However, the impact was alleviated by a strengthening upturn in manufacturing, hinting at a far milder economic downturn than suffered in the first half of last year.” Possible headwinds to the recovery effort in the second quarter could come from a further deterioration in supply delays which has seen waiting times for inputs increase to record levels. Despite the disruptions in supply chains, the vaccine rollouts have boosted sentiment and will aid the recovery once services recover later this year.

UNITED KINGDOM

Contributed by Carel la Cock

- Consumer confidence in the UK improved in February rising from -28 to -23, beating the consensus of -27 and marking an eleven-month high. The rise in sentiment was supported by success thus far in rolling out the vaccines and a steady decline in daily infection numbers. Amongst the sub-indices, four showed improvements: personal finances over the next 12 months (+2); economic situation over the last 12 months (+3); economic situation over the next 12 months (+14); and big purchases climate (+5). Higher sentiment and an increase in personal savings have given hope that there could be a strong consumer driven recovery in the summer months similar to the resurgence in consumer spend following the end of the first lockdown. However, Michael Saunders, external member of the Bank of England Monetary Policy Committee, has warned that the 10% rise in consumer deposits were not broad based and that anecdotal evidence suggests it is concentrated amongst higher earners which might dampen the recovery once the economy opens again. Data from the Office for National Statistics has revealed that consumer spending has fallen sharply at the start of the month, but mostly in categories where purchases have been delayed rather than cancelled, pointing to a strong recovery once lockdown measures are eased.

EMERGING MARKETS AND THE FAR EAST

Contributed by Carel la Cock

- Commodity prices have risen sharply since the height of the pandemic prompting talk of a commodity 'supercycle' last seen in the 2000s. Commodities such as soyabeans, copper and oil have all enjoyed sharp gains this year indicative of the broad-based rally seen in the past six months. Analysts note that it has been unusual to see such broad-based gains and that usually commodities follow different cycles. One explanation is that there is currently a cyclical recovery with demand from developed nations for resources to restock depleted manufacturing inputs, amplified by supply chain disruptions. Some argue that inflation worries caused by ultra-loose monetary and fiscal policy, has driven investors to use hedges using oil and metals, while others point out that global recovery programmes are aimed at protecting and creating jobs while being sustainable to the environment which will support real assets instead of financial assets. Another argument for an increase in demand for commodities is that the transition from carbon based to renewable energy will require significant investment in the decade ahead and will drive demand in metals such as copper used in the wiring of electrical products. Years of low prices has seen under investment in many raw materials and analysts predict a sharp rise in some commodity prices before demand will be met. Rising commodity prices together with a weak Dollar will be significant tailwinds for emerging markets in the coming year.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 13.39	67362
JSE Fini 15	+ 2.69	12384
JSE Indi 25	+ 14.25	89000
JSE Resi 20	+ 17.31	67541
R/$	+ 0.05	14.69
R/€	+ 0.58	17.85
R/£	- 2.73	20.64
S&P 500	+ 3.21	3876
Nikkei	+ 9.88	30156
Hang Seng	+ 11.34	30319
FTSE 100	+ 2.35	6612

DAX	+ 1.69	13950
CAC 40	+ 3.89	5767
MSCI Emerging	+ 8.24	1397
MSCI World	+ 3.65	2788
Gold	- 6.25	1775
Platinum	+ 19.31	1276
Brent oil	+ 21.45	62.91

BOTTOM LINE

Contributed by Nick Downing

- Milton Friedman famously said that "Inflation is the one form of taxation that can be imposed without legislation." Too much inflation is bad, but deflation is even worse and much harder to cure, which prompted the Federal Reserve last year to change its inflation target. The target is now an Average Inflation Target rather than an absolute target, which means that rather than capping inflation at 2% inflation will be encouraged to exceed 2% for a reasonable period of time to compensate for the past ten years when inflation remained stubbornly below that level. The million-dollar question is whether inflation will rise temporarily above 2% or whether the unprecedented levels of monetary and fiscal stimulus in the US and around the world will open the inflationary Pandora's Box and cause an enduring and out of control acceleration. The answer will determine whether the world economy enjoys a short-term cyclical economic recovery lasting a year or two or a much longer-term period of structural expansion which might be sustained for ten years or more.

- Most analysts, economists and fund managers are too young to remember the ravages of inflation in the 1960s and 1970s. In the US inflation hit a high of 15% in 1980, just before Ronald Reagan was elected President. Reagan said that "Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Once inflation exceeds the 20% tipping point, it quickly spirals out of control with massive social consequences. Runaway hyper-inflation in Germany in the 1920s was the catalyst leading to WW2. In Zimbabwe, the current inflation rate stands at around 800%, wreaking misery on its economy and population.

- Under the leadership of Federal Reserve Chair Paul Volker, US inflation was brought under control in the early 1980s, but it wasn't easy. He had to lift the fed funds interest rate from 11% to a peak of 20% in June 1981, a huge burden for indebted businesses and households. In South Africa short-term interest rates went even higher in the mid-1980s, hitting a peak of 25% in 1985 while inflation briefly exceeded 20%.

- Inflation is not currently a problem, but inflation expectations are rising rapidly off a low base. The financial market has priced in a sharp increase in the expected US average inflation rate over the next ten years. According to the breakeven rate between 10-year Treasury Inflation Protected Securities and conventional Treasury bonds of the same maturity and according to the 10-year CPI swap rate, the market's expected inflation rate has accelerated to around 2.2%, the highest since 2014 up from less than 1% at the height of the Covid pandemic last year.

- The policy response to the pandemic has been unprecedented in terms of the sheer volume of money printing by the world's central banks. The volume of new money creation dwarfs the monetary expansion following the 2008/09 Global Financial Crisis (GFC). Moreover, unlike post GFC the bulk of new money created is ending up in the real economy due to the largesse of government aid programmes, which were conspicuously absent after 2009. Broad money supply, which comprises household and business cash and deposits in the banking system, increased by $5 trillion in 2020. Businesses and household are awash with cash. Household savings have jumped as a percentage of disposable income, creating a vast pool of latent demand. This is a worldwide phenomenon. Meanwhile, the world's second largest economy China, is shifting from an export driven into a consumer driven economy. The process is gradual but will significantly boost aggregate global demand for goods and services, all at a time of rising global protectionism, which is an added inflationary pulse.

- The Federal Reserve, which governs the world's reserve currency, disagrees that inflation is a risk. The Fed admits that inflation will jump temporarily due to the base effect of extraordinarily low comparative numbers in the first half of last year at the start of the Covid pandemic. However, the inflation spike is not expected to endure. Unemployment remains elevated. Of the 20 million people who lost their jobs in the US in March and April last year, around 10 million are either still unemployed or have given up looking for jobs. The labour market and service and manufacturing sectors across the world are currently exhibiting significant excess capacity. It is hard to envisage the expected short-term inflation spike becoming entrenched while there is such a yawning global output gap.

- The inflation doves believe that besides the elevated output gap, which will take a long time to fill, Covid has accelerated significant longer-term disinflationary structural changes. As Lenin said, "There are decades where nothing happens; and there are weeks where decades happen." Technological innovation has been a deflationary force in recent years but the adoption of cost saving technology and digitisation has accelerated during Covid. Examples include cleaner and cheaper energy, digital conferencing, online retailing, remote learning and revolutionary health diagnostics. There are many more, all contributing to a potential productivity boom over coming years, cutting the cost of production of goods and services. The remarkable shift towards working from home" is one of the biggest changes, reducing travel and accommodation costs and allowing families to migrate from tier one cities to locations with a lower cost of living. Depending on the country, rents comprise the bulk of the consumer price inflation basket, between 30-40% depending on the country. In the US it comprises 40% of the core CPI basket.

- There is fierce debate, the jury is still out on the inflation conundrum. Getting the right answer will make a significant contribution to a successful investment outcome over coming years. As inflation rises, even if temporarily, longer-dated government bond yields will also increase. The 10-year US Treasury bond yield has already jumped from 0.50% since mid-2020 and 0.95% at the end of last year to the current level of 1.30%, making some investors anxious. However, it can still rise a long way from current levels and probably will, without derailing the economic cycle and equity bull market. The long-bond rate, which sets the bar for the global cost of capital, will only choke off economic growth and the equity market once it exceeds nominal GDP growth and this is unlikely to occur for some time, especially given the robust economic growth forecasts over the next 1-3 years.

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