OVERBERG MARKET REPORT

Tuesday 30th March 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- The world economy is recovering quickly and is expected to roar ahead by the second half of the year. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Consumer inflation eased more than the consensus expected, to 2.9% year-on-year in February down from 3.2% in January. The latest reading is below the 3%-6% target range of the South African Reserve Bank (SARB). The easing of the Consumer Price Index (CPI) reading to below the central bank's lower inflation limit of 3% was driven by moderate medical insurance price increases. Among the main contributors of year-on-year inflation were food and non-alcoholic beverages - which increased 5.2%, housing and utilities - which increased by 2.6%, and miscellaneous goods and services which increased by 3.9%. Core inflation was also slightly lower than expected, at 2.6% year-on-year. On a month-on-month basis, consumer inflation increased by 0.7%. Looking ahead the SARB expects headline consumer price inflation for 2021 to be higher at 4.3% (up from 4.0%) and for 2022 slightly lower at 4.4% (down from 4.5%). The forecast for 2023 is 4.5%. The SARB further noted in its Monetary Policy Committee (MPC) statement that the overall risks to the inflation outlook appear to be balanced. A stable exchange rate in recent months, and generally low pass-through in costs, are expected to continue to moderate inflationary pressures. However, higher oil and electricity prices remain upside risks to the inflation trajectory.

- The South African Reserve Bank kept its repo rate unchanged for a fourth straight meeting. The Monetary Policy Committee (MPC) kept the repurchase rate at 3.5% (prime rate at 7%), the lowest level since it was introduced in 1998. The SARB expects Gross Domestic Product (GDP) to grow by 3.8% in 2021, 2.4% in 2022 and by 2.5% in 2023. The bank's Quarterly Projection Model (QPM) indicates an increase of 25 basis points in the repo rate in each of the second and fourth quarters of 2021. Regardless, various economists believe that rates will stay unchanged throughout the year given the continued support needed by the economy accompanied by the muted inflation outlook. The SARB noted that economic and financial conditions are expected to remain volatile for the foreseeable future and that the

MPC will seek to look through temporary price shocks and focus on second round effects before increasing interest rates.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- Private Sector Credit Extension, due Tuesday 30 March. Private sector credit extension (PSCE), which reflects general economic activity as well as consumer and business confidence, is expected to have recorded a slight improvement in February after it weakened to 3.3% year-on-year in January from 3.6% in December 2020.

- Balance of Trade, due Wednesday 31 March. The balance of trade is anticipated to have recorded a surplus for the tenth consecutive month in February, projected to have increased to R18.8 billion in February up from R11.83 billion in January.

- ABSA Manufacturing Purchasing Managers' Index, due Thursday 1 April. The manufacturing purchasing managers' index (PMI), which is a reliable monthly indicator of manufacturing activity and an early indicator of underlying economic activity in South Africa, is expected to have declined slightly in March to 52 from 53 recorded in February.

- Total New Vehicle Sales, due Thursday 1 April. The slow recovery in new vehicle sales as a result of rising demand for used vehicles, high unemployment and economic uncertainty is expected to have turned a corner in March. The consensus forecast is for new vehicles sales to have increased 15.2% year-on-year, compared with a 13.3% decline in February. This improvement is however attributed to the low base established in March 2020 when Covid-19 first surfaced. New vehicles sales still have a long way to go to recover to pre-pandemic levels.

GLOBAL

Contributed by Nick Downing

- The US 10-year Treasury bond yield has climbed to its highest level since the start of the pandemic, rising to 1.74%, up significantly from 0.90% at the end of 2020 and 0.55% in mid-2020. The yield is rising in anticipation of a V-shaped US and global economic recovery, but also due to rising inflation expectations. The yield provides the basis for the global cost of capital. The market is pricing-in an expected average US inflation rate of 2.68% over the next five years, based on the yield difference between conventional Treasury bonds and Treasury Inflation Protected Securities (TIPS). Financial markets are likely to take the current expected inflation rate in their stride but may start rioting if it exceeds 3%, which many economists believe will occur due to massive fiscal and monetary policy stimulus combined with successful vaccination rollouts and the reopening of economies. There are already signs of inflation in supply chains which are battling to keep up with renewed global demand. However, central bankers are not perturbed. They admit that inflation may rise but it will be short-lived. The Federal Reserve forecasts consumer price inflation will accelerate to 2.4% in the fourth quarter of this year but then subside in the following two years to slightly above 2%, in line with its target. Other economists and fund managers agree that the long-term disinflationary structural forces such as technological innovation, globalisation and deregulation will counteract the reflationary fiscal and monetary policy impact. The considerable slack in labour markets should help too, especially in a world with progressively reduced labour union power. Long-term bond bulls will be tempted to buy the 10-year Treasury yield at 1.74% particularly while purchases can be financed at close to zero percent short-term lending rates. The Fed has committed to anchoring the fed funds rate at 0-0.25% at least until 2024.

NORTH AMERICA

Contributed by Nick Downing

- Following the Federal Reserve's policy meeting on 16-17th March at which monetary settings were left unchanged with a fed funds rate of 0-0.25% and monthly asset purchases at $120 billion, Fed chair Jay Powell testified with Treasury secretary Janet Yellen before both houses of Congress. In his testimony to the Senate Banking Committee, Powell reiterated recent statements concerning the impact of surging economic activity on inflation. He said "We might see some upward pressure on prices. Our best view is that the effect on inflation will be neither particularly large nor persistent." Powell also sought to soothe concerns over the sharp increase in the 10-year Treasury bond yield, attributing the increase to the improved economic outlook while putting the higher yield in the context of a natural adjustment from extraordinarily low levels last year. He said the yield adjustment "has been an orderly process." Meanwhile, Janet Yellen emphasised that although the recent additional $1.9 trillion fiscal stimulus would lift federal debt, estimated to reach 102.3% of GDP in the current fiscal year, total interest payments were largely unaffected due to historically low interest rates.

- Household income and consumer spending fell in February, although the declines had been expected as the once-off $600 stimulus cheques paid to individuals in January, fell out of the equations. Household income fell by 7.1% month-on-month, reversing a portion of January's 10.1% increase. Consumer expenditure declined by 1.2% on the month, although the decline was offset by an upward revision of similar magnitude to January's figure. Despite February's setback, the outlook remains extremely bright, as the next round of once-off stimulus cheques funded by the $1.9 trillion American Rescue Plan are being distributed and amount to an increased $1400. These cheques will boost household savings, which had already amassed to $3.9 trillion in January up from $1.4 trillion in February 2020. Assisted by the rapid vaccination rollout, an easing in lockdown restrictions, jobs growth and improved weather, consumer expenditure is likely to rebound sharply in March, and over coming months, which bodes well for GDP growth. Consumer spending comprises around two-thirds of US GDP. In the first quarter, consumer spending is expected to increase by close to 10% annualised.

JAPAN

Contributed by Carel la Cock

- Japanese private sector activity remained subdued in March according to the latest Jibun Bank Flash Japan Composite PMI which reported a reading of 48.3 compared to 48.2 in February. The manufacturing PMI showed slightly improved conditions rising to 52.0 from 51.4 a month before while the Services Business Activity Index rose to 46.5 from 46.3 in February but remains stuck below the key 50-level separating growth from contraction. New orders in both manufacturing and services experienced an improvement from the month before, but manufacturing employment saw a third consecutive monthly decline in contrast to the services sector which reported the fastest pace of job creation since May 2019. Both sectors remained positive on the outlook with hopes that the easing of the state of emergency and further vaccine rollouts will lead to improved domestic and global demand.

EUROPE

Contributed by Carel la Cock

- The IHS Markit Flash Eurozone PMI for March has beaten expectations and showed an expansion in private sector business activity driven by the fastest growth in manufacturing since June 1997 coupled with a softer contraction in the services sector. The Flash Eurozone Manufacturing PMI Output Index rose to 63.0 in March from 57.6 February while the Flash Eurozone Services PMI Activity Index improved to 48.8 from 45.7. Manufacturing in the region was boosted by record growth in factory production in Germany and the fastest growth in production in the rest of the region in over three years. Germany also saw an expansion in service sector activity in contrast to the rest of the region that experienced a contraction, albeit at a slower pace. Overall, Germany reported the fasted rate of expansion with a Composite PMI of 56.8 compared to 49.5 for France and the rest of the region at 50.6. The survey results have also highlighted the impact of continued delays in delivery times on both input prices and output prices. Cost inflation is currently close to a decade high and output prices have risen sharply stoking fears that cost pressure could lead to consumer inflation in the coming months.

UNITED KINGDOM

Contributed by Carel la Cock

- Economic data from the UK has consistently exceeded expectations in the past quarter prompting economists to adjust their economic growth forecast upwards for the first quarter of the year. The UK government has been more successful than its European peers in rolling out the covid-19 vaccine and as a result lockdown measured will be eased in contrast to Germany, France, and Poland where a third wave is forcing governments to implement more stringent measures. The UK private sector has been more resilient during the second wave of covid-19 and has adapted to the restrictive measures leading to output, employment and business sentiment all faring better than first expected. The Bank of England forecast a 4.2% drop in output in the first quarter back in February, but external member, Michael Saunders, has indicated that the economy is expected to have improved from that level. Economists are putting the expected contraction in first quarter GDP in a range of between 1% and 2.5%, admitting that economic data released thus far has been much stronger than expected. Some of the economic data backing the rise in expectations include improved retail sales in February, mortgage approvals in January at levels last seen a decade ago, and unemployment falling in February. Much of the improvement in sentiment comes from the way that business and consumers have adapted to life in lockdown which has made it difficult for economist to predict future growth. However, most economists now agree that the UK is well positioned to recover to pre-pandemic levels sooner than anticipated.

EMERGING MARKETS AND THE FAR EAST

Contributed by Carel la Cock

- The IHS Markit India Business Outlook has revealed that business activity optimism improved in February and output expectations are now the highest in over six years. Employment is also expected to improve, and capital expenditure is set to increase in the year ahead. The improvement in the business outlook is largely driven by the belief that the vaccine rollout will boost demand. The service sector has seen an improvement in confidence citing the availability of vaccines as a major opportunity for the sector, while sentiment in the manufacturing sector, still at the highest level since late 2012, was unchanged from the previous survey in October. Private sector firms expect employment levels and capital expenditure to increase over the next 12-months as companies take advantage of new business opportunities. Firms in both services and goods production indicated that the expected rise in labour costs will be passed on to consumers with fees in both sectors set to rise. Overall, Indian firms expect an improvement in profitability in the coming year while the level of optimism was above the average for emerging markets.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 12.93	67089
JSE Fini 15	+ 3.19	12445
JSE Indi 25	+ 13.51	88427
JSE Resi 20	+ 16.25	66931
R/$	- 1.48	14.91
R/€	+ 2.30	17.55
R/£	- 2.16	20.52
S&P 500	+ 5.72	3971
Nikkei	+ 7.07	29384
Hang Seng	+ 4.07	28338
FTSE 100	+ 4.27	6736
DAX	+ 8.01	14817
CAC 40	+ 8.36	6015
MSCI Emerging	+ 1.46	1310
MSCI World	+ 4.52	2811
Gold	- 8.85	1726
Platinum	+ 7.53	1150
Brent oil	+ 24.65	64.57

BOTTOM LINE

Contributed by Nick Downing

- As is often the case, strong economies do not necessarily make for strong equity markets. Since the start of the year, the economic outlook has improved by leaps and bounds and yet the response from equity markets has been modest. Contrast this with last year when equity markets surged despite deepening uncertainty over the Covid pandemic. The paradox is partly explained by the fact that when economic activity recovers, there is increased demand for liquidity from the real economy, which inevitably is drawn from financial markets.

- The world economy is recovering quickly and is expected to roar ahead by the second half of the year. Vaccination news has been encouraging. The US and UK have led the way with their rapid vaccination rollouts, but other regions will soon follow, which should result in a full removal of restrictions across the developed world by mid-year. At the same time, the world's central banks have pledged to maintain existing monetary policy stimulus to ensure with concrete certainty that economic recovery is sustainable. Fiscal stimulus is also leaving nothing to chance. President Joe Biden managed to enact the $1.9 trillion American Rescue Plan in quick time, made possible by the narrow Congressional Democrat majority. US fiscal aid in 2021 will exceed 12.5% of GDP, even more than last year's stimulus which amounted to 11% of GDP. Fiscal activism has become a global phenomenon, with expansionary government spending expected to continue over a 3-year horizon to avoid the mistake made after the 2008/09 Global Financial Crisis when austerity was introduced too early.

- The Organisation for Economic Cooperation and Development (OECD) has increased its global economic growth forecast. Global GDP is now expected to grow by 5.6% in 2021, up sharply from December's forecast of 4.2%, boosted by a substantial upgrade to its US growth forecast from 3.2% to 6.5%. The OECD said inflation bottlenecks may occur in certain areas but will likely be temporary. Sustained inflation would require a pick-up in wages, which is hard to envisage given the Covid induced slack in labour markets.

- Inflation expectations have risen since the start of the year, borne out by rising breakeven rates between conventional US Treasury bonds and Treasury Inflation Protected Securities. The 10-year breakeven rate, which measures the financial market's projected annual rate of consumer price inflation over the next ten years, has increased to 2.31% up from 1.96% at the end of December. In anticipation of a strengthening economy and rising inflation expectations, the yield on the 10-year Treasury bond has shot higher over the same period from 0.91% to 1.74%.

- The jump in bond yields has affected the discount rate used to value equities, which has had a pronounced impact on last year's Covid winners, in particular the shares of technology and digitally enabled companies. These shares had become overvalued and while discounting so many years' growth into the future were particularly susceptible to an increase in the discount rate (10-year Treasury bond yield). Shares like Tesla have tumbled from their recent highs. However, despite the technology sector comprising close to 22% of global market capitalisation, the sector's derating has had minimal impact on broader equity indices.

- While technology stocks have de-rated, this has been offset by a pronounced rally in cyclical and value stocks, especially in the energy, commodities, banks, financials and consumer service sectors, which were left behind in last year's rally and as a result still trade at cheap levels. Moreover, as well as being extremely cheap, these sectors enjoy better earnings leverage to the cyclical global economic recovery. The so-called "reopening basket" continues to trade at a significant discount to its pre-Covid levels and to its long-term average, while earnings growth is likely to accelerate, as the world's economy reopens, and the taps open from the massive pool of excess household savings.

- At some point rising bond yields will affect all sectors of the equity market. However, this is a long way off. The 10-year US Treasury yield, 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 far from being the case in the context of current stellar GDP forecasts. Global real GDP growth is expected to hit 5.6% in 2021, which after adding the inflation rate of 1.5%, translates into nominal GDP growth of 7.1%, considerably above the 10-year yield even if it does rise further from 1.63% to 2.5%, as many expect. In fact, by the time world economic growth hits the projected nominal growth pace of 7.1%, there will effectively be even more stimulus than there is today, as the gap between real interest rates and nominal GDP growth will be even wider. The Federal Reserve and other major central banks are committed to anchoring short-term interest rates at zero and maintaining their current pace of asset purchases. According to current projections from the Federal Reserve, this ultra-accommodative policy mix will last at least until 2023 as its inflation and employment goals are not expected to be met before then.

- Fed chairman Jerome Powell has repeatedly stated that the Fed is "still a long way from our goals of maximum employment and inflation averaging 2% over time." He 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 Fed expects the inflation spike to be transitory, with the inflationary impulse from unprecedented fiscal and monetary stimulus offset by considerable slack in the labour market and the adoption of cost saving technologies and digitisation, which was accelerated by Covid.

- While the large reserve of global liquidity will to a large extent by diverted from financial assets to the real economy, equity markets are expected to continue rising albeit not at the break-neck speed of late 2020. The equity market will remain resilient despite the rapid increase in bond yields as the cost of capital remains historically low and global corporate earnings are expected to surge as the year progresses. Equities tend to enter a bear market if rising bond yields coincide with a slowing economy, which is certainly not the case in the current environment of rapidly accelerating GDP growth. Bond yields are expected to rise in a step-like formation, with the ascent plateauing every time the equity rally pauses. This is quite different from typical bear markets, when bond yields continue rising even as equity markets decline. We feel the bigger risk to equity markets is medical rather than financial although we remain confident that the vaccination rollout will be effective in defeating the Covid pandemic. Although sector performance will vary considerably as economies and markets normalise, overall equity indices are expected to register further gains as the year progresses.

Disclaimer