OVERBERG MARKET REPORT

Tuesday 1st June 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- Former US Treasury secretary Larry Summers warns that fiscal and monetary policy makers have "underestimated the risks, very substantially, both to financial stability as well as to conventional inflation of protracted extremely low interest rates" but Fed chair Jay Powell and the majority of economists are in disagreement. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Kirk Swart

- The Rand held onto its strong performance against the US dollar, settling well below the R14/$ mark. It is very encouraging to see that despite the robust currency and the notable decline in some of South Africa`s commodity exports, the JSE held up very well last week. This is due to many local companies delivering good numbers, especially in the retail space. Despite the macro-economic headwinds, companies such as Dis-Chem and Mr Price are growing market share as consumer behavior is moving from large shopping malls to smaller community-based retail outlets. Online retail sales are experiencing exponential growth. The last two consecutive weeks have seen SA government bond yields decline. The low global interest rate environment, along with easing fears of inflation, have led to strong demand for South Africa's government bonds. The carry trade is still strong.

- Further tailwinds include the news that Eskom managed to lower its massive debt pile by almost 20%. Eskom managed to reduce its debt by R83 billion last year. The figure surprised many as Eskom reduced its debt from R484 billion to R401 billion. Still at unsustainable levels, at least the decline in debt is encouraging as it changes the trajectory of the debt curve. The debt reduction is due to two reasons. Firstly, Eskom paid back more debt than it raised in new debt. Eskom paid back R65 billion and managed to raise R15 billion. The second reason is the strengthening of the rand with a portion of the debt being dollar-based. Eskom will continue to pay back more debt than it raises every year combined with a constrained capital spending outlook. Although positive, the power utility will still rely on the taxpayer to keep the lights on as the debt levels are still enormous. It is expected that after the planned split of Eskom into three separate business units, Generation will be responsible for 50% of the debt, with Transmission and Distribution each being responsible for 25% of the debt.

- As daily new Covid-19 cases in South Africa continue to rise, President Cyril Ramaphosa announced on Sunday night some tightening in lockdown restrictions. South Africa has been moved to adjusted level 2 covid restrictions. This is a softer approach from the government which is focused on curbing social mobility whilst keeping the economy open. The following changes are being implemented: The evening curfew will start one hour earlier at 11 pm and end at 4 am. Non-essential services like restaurants, bars, and gyms will have to close by 10 pm. All gatherings will be limited to a maximum of 100 people indoors and 250 people outdoors. No additional restrictions were placed on the liquor and hospitality industries. The situation will be continually monitored.

- Producer Price Inflation (PPI) increased by 6.7% y/y in April following a 5.2% increase in March. This was below the consensus figure of 7.1%. If petroleum-related products are excluded, PPI was steady at 5.5% which is unchanged from the 5.5% March reading. On a month-on-month basis, PPI increased by 0.7%. Data suggests that the increase in PPI is not broad-based, but rather influenced by individual prices. The jump in petroleum-related prices can be attributed to the low base effect following the 7.4% m/m decline between March 2020 and April 2020. This is a normalization of petroleum-related prices with global economies starting to reopen. There is consensus that PPI will peak at 7.4% in May and will steadily moderate to around 5.1% by the end of the year.

- The M3 money supply measure increased by 2.02% y/y in April. Although it increased annually, M3 money supply declined slightly on a month-on-month basis to R4.142 billion in April from R4.111 billion in March. M3 money supply is used by economists and policymakers as a gauge of the entire money supply within an economy. It is a useful tool when making interest rate policy decisions. Private Sector Credit Extension (PSCE) in April recorded a negative reading of -1.76%. This is the second consecutive negative reading following March's -1.52% decline. Meanwhile, the South African balance of trade recorded a surplus of R51.240 billion in April slightly below the R52.770 billion surplus in March but nonetheless impressive given the elevated base and well above the consensus forecast of R37.5 billion. Robust commodity prices will likely continue to support the trade surplus in the near term. Year-on-year world trade volumes have improved by more than 25% over the last ten months alongside the world economy's recovery from the Covid-19 pandemic.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- ABSA Purchasing Managers' Index, due Tuesday 1 June. The ABSA manufacturing purchasing managers' index (PMI) is expected to have contracted slightly to 55.5 in May, from

56.2 in April. This slight pullback is expected to result from load-shedding and the strains imposed by global supply shortages.

- Unemployment Rate, due Tuesday 1 June. The jobs data for the first quarter of 2021 is expected to paint a bleak picture, with the consensus forecasting a record high unemployment rate of 33.4%, up from 32.5% in the final quarter of 2020. The expected increase is attributed to new job seekers entering the labour force.

- Total New Vehicle Sales, due Tuesday 1 June. The new vehicle sales data, a key indicator of the health of the consumption side of the economy, is forecast to have normalised in May following the pullback in April sales which resulted from reduced trading days in the month. The consensus forecasts an increase to 42 098 units from 35 779 the previous month.

- Standard Bank Purchasing Managers' Index, due Thursday 3 June. As with the ABSA PMI, the Standard Bank/IHS Markit PMI is expected to have contracted slightly to 52.3 in May, from 53.7 in April, also due to load-shedding and strains of global supply shortages.

GLOBAL

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- The OECD upgraded its forecasts for global GDP growth in 2021 from 5.6% to 5.8% and in 2022 from 4% to 4.4%, bringing most of the world to pre-pandemic GDP levels by the end of 2022. In the updated Economic Outlook report, the OECD predicted global inflation will rise from 1.5% in 2020 to 2.7% this year but then subside to 2.4% in 2022. According to the report, "As long as inflation expectations remain well anchored and wage growth remains subdued, we are confident that central banks will remain vigilant but look through these temporary price rises. What is of most concern, in our view, is the risk that financial markets fail to look through temporary price increases and relative price adjustments, pushing market interest rates and volatility higher." While upbeat about the global economic recovery, the OECD cautioned that some countries remain at risk due to uncertain vaccine supplies, which could eventually jeopardise the broader world economy if left unchecked. OECD chief economist Laurence Boone noted that emergency fiscal relief should give way to more targeted fiscal support focussed on investment spending, especially in climate transition, digital migration, health and education spending. The menu sounds very similar to US president Joe Biden's proposed infrastructure and social upliftment spending plans.

NORTH AMERICA

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- The Federal Reserve's favoured inflation measure, the personal consumption expenditure index (PCE), increased more than expected in April. Headline PCE increased 0.6% month-on-month and 3.6% year-on-year, up sharply from 2.4% in March. Core PCE, excluding food and energy prices due to their volatility, increased 0.7% on the month and 3.1% on the year, up from 1.9% in March and above the consensus forecast of 2.9%. The Fed is sticking with its forecast that the current inflation spike will be transitory, attributed to the sudden reopening of economies, fiscal support, pent-up demand and the statistical base effect of abnormally year-ago comparative data. The market is going along with this view, evidenced by the muted reaction in the 10-year Treasury bond yield, which barely budged after the data release, anchored at 1.61% compared with its recent March peak of 1.77%. While some Fed policy makers feel that discussion should be initiated on the potential reduction in the central bank's monthly asset purchases, the initiative remains very tentative. San Francisco summed it up when she said, "we are talking about talking about tapering." Household income fell in April by a massive 13.1% month-on-month, as the effect of one-off fiscal support cheques faded, illustrating perhaps that consumer demand will eventually come off the boil and so too the current inflationary impulse. Consumer spending also showed signs of losing momentum in April. Although spending on services increased 1.1% on the month spending on goods dropped by 0.6%, resulting in an aggregate gain in consumer spending of just 0.5%.

- President Joe Biden has proposed a larger than expected annual White House budget of $6 trillion, with an emphasis on investment spending on infrastructure, health care and education. Despite the extravagant expenditure, the White House estimates the government deficit will reduce from $3.67 trillion in 2021 to $1.84 trillion in 2022, assisted by the powerful economic recovery and plans to increase the corporate tax rate from 21% to 28% and the top capital gains tax rate from 23.8% to 43.4%. However, public debt is projected to rise to 111.8% of GDP in 2022, higher than any since WW11. While debt levels are surging, total interest payments have benefitted from the Fed's zero interest rate policy, which is expected to remain in place until 2024. Shalanda Young, acting director of the Office of Management and Budget, said that "failing to make these investments at a time with such low interest costs would be a historic missed opportunity that would leave future generations worse off." The opinion contrasts with the predominant Republican view that Biden's spending plans will lead to painful tax hikes, runaway inflation and an increased debt burden for future generations.

CHINA

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- The official National Bureau of Statistics manufacturing purchasing managers' index (PMI) remained above the expansionary 50-level for a 15th straight month but slipped slightly in May from 51.1 to 51.0. Among the PMI sub-indices, the input price index surged to 72.8 due to pressure from rising commodity prices. Export demand also weakened, with the forward-looking new export orders index dropping below 50. Export demand is being hamstrung by the appreciating yuan, which has gained by 10% versus the US dollar since the start of the year, breaching the Y/$6.40 level for the first time since June 2018. The People's Bank of China will want to prevent the yuan from appreciating excessively due to the impact on the economy's terms of trade but at the same time a strong yuan makes commodity imports more affordable. Separately, the services PMI gained in May from 54.9 to 55.2, boosted by renewed spending on leisure and travel. Consumer spending had been lagging the recovery in industrial production but now looks as though it is taking up the slack. China's top policy making body, the Communist party politburo, last week decreed that families would now be allowed to have three children. The shift from the two-child policy introduced in 2015, is aimed at boosting the country's birth rate, which according to the 10-year census published in April, had dropped for a fourth straight year.

JAPAN

Contributed by Nick Downing

- Industrial output increased in April by 2.5% month-on-month up from a 1.7% increase in March, helped by export demand for machinery equipment from the US and China. However, the increase was below the consensus forecast growth rate of 4.1% due to the impact of semiconductor chip shortages on the vehicle manufacturing sector. Meanwhile, retail sales continued to decline, falling in April by 4.5% on the month, attributed to continuing Covid restrictions which are due to remain in place until 20th June. The consumer sector is expected to remain weak in May and June, which may cause the economy to shrink for a second straight quarter in the second quarter (Q2) following its contraction in Q1. The official Cabinet Office consumer confidence index posted its second straight monthly decline in May, falling from 34.7 to 34.1. Despite progress with the vaccine rollout, three of the four key survey measures showed declines including overall economic well-being, income conditions and the labour market, while sentiment towards buying durable goods remained stable. The share of respondents projecting an increase in consumer price inflation dipped from 76.0% to 74.9%. The government downgraded its view on consumer confidence, saying the pace of recovery had slowed.

EUROPE

Contributed by Nick Downing

- Following its double-dip recession in the first quarter of the year, the Eurozone economy is set to surge in the second quarter and into the latter half of the year. The European Commission (EC) sentiment index, compiled from business and consumer readings, increased sharply in May from 110.5 to 114.5 its highest since January 2018, powered by the services reading which increased from 2.2 to 11.3. Service sectors, which comprise two-thirds of

Eurozone GDP, are benefiting from the lifting of Covid restrictions. Although the improving outlook was broad-based across the region, France and Italy showed the biggest gains due to their exposure to travel and tourism. Italy's sentiment index increased to its highest since 2000, boosted additionally by prime minister Mario Draghi's economic reforms. Meanwhile, policy makers from the European Central Bank poured cold water on speculation of an early withdrawal from the central bank's asset purchase programme, the €1.85 trillion pandemic emergency purchase programme (PEPP) which is due to run until at least March 2022. ECB executive board member Fabio Panetta said that "a premature withdrawal of policy support would risk suffocating the recovery before it becomes self-sustaining." The region can look forward to a further stimulus to growth in the second half of the year when the €750 billion EU recovery fund will be formally launched. The fund is aimed at long-term infrastructure and investment spending.

UNITED KINGDOM

Contributed by Nick Downing

- The Confederation of British Industry's (CBI) monthly Growth Indicator showed UK private sector activity expanding in the three months to May by a massive 30% on the quarter, up from 1% the previous month. Alpesh Paleja, lead economist at the CBI reported that "as the country slowly but surely reopens, the economy has really taken off. Most sectors have seen a real uplift in activity in recent months and believe that the outlook for the summer is strong." The CBI forecasts the monthly Growth Indicator will accelerate further to 42% growth in the coming three months. The OECD increased its forecast for UK GDP growth in 2021 to 7.2% from 5.1% in March, making it the fastest growth rate among developed economies, attributed to a successful vaccination programme and the government's Plan for Jobs. However, the strength of the recovery is also attributed to the depth of the recession in 2020, which was one of the world's most severe. The OECD cautioned that increased border costs resulting from Brexit will affect the UK's foreign trade competitiveness, and that the expiry of the furlough scheme will cause the unemployment rate to jump to 6.1% by the end of the year well above the 2019 level of 3.8%.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 14.40	67964
JSE Fini 15	+ 11.57	13455
JSE Indi 25	+ 11.52	86872

JSE Resi 20	+ 17.53	67666
R/$	+ 6.95	13.74
R/€	+ 6.84	16.80
R/£	+ 2.81	19.53
S&P 500	+ 11.93	4204
Nikkei	+ 5.16	28860
Hang Seng	+ 7.05	29151
FTSE 100	+ 8.70	7022
DAX	+ 12.41	15421
CAC 40	+ 16.14	6447
MSCI Emerging	+ 6.58	1376
MSCI World	+ 10.62	2975
Gold	+ 0.21	1896
Platinum	+ 10.51	1182
Brent oil	+ 33.84	69.33

BOTTOM LINE

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- The Federal Reserve is actively encouraging higher inflation. Last year it changed its inflation target from 2% to an average of 2%, allowing periods of overshoot to make up for the past 10 years when inflation struggled to meet the target. The bigger structural problem we face today, recognised by the Fed and the world's major central banks, is not inflation but deflation. Japan has struggled with deflation for decades. Deflation is much harder to fix than inflation, and tends to result from an ageing population, more prone to saving than spending. An ageing population is evident throughout the western world and now also in China according to its recent census. Excessive debt is also deflationary. The world is drowning in debt, a situation worsened by the Covid pandemic, which prompted governments to resort to massive fiscal rescue remedies.

- The Fed, followed by other central banks, is keenly aware that with global debt rising ever higher, it needs at all costs to avoid a deflationary trap. If it fails, the debt problem will become even greater in real terms, ultimately resulting in depression. To avoid this outcome, the Fed is purposefully staying behind the inflation curve. But will it go too far, will the increase in inflation be the saviour or will it get out of control and become a villain? The consensus opinion is that 3% is the threshold. In April, US consumer price inflation jumped from 2.6% to 4.2% year-on-year, but this had been anticipated due to the base effect of last year's low comparative readings at the outset of Covid lockdowns. We will only know whether the inflation spike is persistent or temporary, as the Fed claims it will be, once the base effect washes out of the data, sometime next year.

- Former US Treasury secretary Larry Summers warns that fiscal and monetary policy makers have "underestimated the risks, very substantially, both to financial stability as well as to conventional inflation of protracted extremely low interest rates" but Fed chair Jay Powell and the majority of economists are in disagreement. In his testimony to the Senate Banking Committee, Powell 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." The Fed's argument is that there is significant under-utilised production capacity in businesses and in the labour market, which will keep a cap on longer-term inflation. The short-term spike will fade as supply chain bottlenecks are fixed and labour market restrictions are removed in line with an easing of Covid restrictions. Joe Biden is planning an additional $4 trillion in fiscal stimulus, but expenditure will be spread over 10 years and much will go towards infrastructure improvement, which should boost productivity and therefore be disinflationary. Meanwhile, the ageing global population, technological innovation, global trade, deregulation and the falling influence of labour unions, remain powerful disinflationary trends, and since Covid perhaps more relevant than ever.

- Some argue that the rapid acceleration in economic growth resulting from the sheer scale of fiscal and monetary stimulus, the strength of household balance sheets following government helicopter drops of money, and pent-up demand, will endure beyond the initial reopening phase. The fear is less of a spike in inflation than a rise in inflation expectations. Once inflation expectations become entrenched, they are very difficult to shake off. According to the University of Michigan US consumer confidence survey in May, respondents are already expressing concerns about inflation and its effect on their purchasing power. Survey respondents regarded buying conditions for durable goods, cars and homes as the most negative since 1980. With pent-up demand so strong, companies are able to pass on higher production costs to consumers and are doing so on an opportunistic level even where cost pressures are not yet visible. US GDP could grow in 2021 by as much as 8%, the Eurozone by 6%, and the world economy by around 6%, but growth will slow in 2022 and return back to trend growth thereafter, so demand pressure should ease at the same time that supply bottlenecks are mended.

- April's US consumer price inflation figure, although a shock at the headline level, provided more sober reading upon closer analysis. The chief culprits were the sectors with demand surges resulting from the removal of Covid restrictions. On a month-on-month basis, airline fares, hotel prices and car rental prices increased by 10.2%, 7.6% and 16.2%. By contrast, medical care services were unchanged. Rents, which contribute the lion's share of the CPI basket at 30% and an even greater 40% share of core CPI, increased just 0.2% on the month. Arguably rents will be under sustained downward pressure as the "work from home" phenomenon outlasts the pandemic and continues to encourage people to move to larger homes in cheaper suburbs and metros.

- It is telling that upon the release of the April inflation data, the inflation hedges dropped in price. 10-year Treasury Inflation Protected Securities (TIPS) suffered their biggest daily decline in a month. The breakeven rate between the conventional 10-year Treasury bond and same maturity TIPS, which indicates the market's expected average annual inflation rate over the period, dropped to 2.41%, down from 2.54% before the data was released.

- The debate over the inflation threat is still wide open. We will probably only know the answer in 2022 after the once-off effects have had time to fade out of the equation. Until then, therefore, financial markets are likely to give the Fed the benefit of the doubt, even if short-term spikes are uncomfortably high. Longer-term bond yields may rise but as long as shorter-term bond yields remain anchored, which is the expected scenario given the Fed's pledge to keep the fed fund's rate at zero at least through 2023, global equities are likely to continue being well supported.

- In South Africa, inflation is less of a worry. While we have not had to deal with the threat of deflation, inflation is also a low-risk outcome given the stresses on household balance sheets. We did not share in the luxury of massive fiscal handouts and unemployment is extremely high at over 30%. Moreover, the rand is underpinned by strong terms of trade and buoyant commodity prices, thanks to the powerful recovery in global trade. A stable rand will shield against imported inflation. Benign inflation and a stable rand, coupled with high long-term interest rates (amongst the highest long-term government bond yields in the world), should enable the Reserve Bank to maintain its accommodative low interest rate policy.