OVERBERG MARKET REPORT

Tuesday 29th June 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- There is no doubt that the economy is recovering. In the first quarter (Q1), South Africa's GDP beat expectations with growth of 4.6% quarter-on-quarter annualised, slowing from 5.8% in Q4 2020 but far better than the Reserve Bank's 2.7% forecast. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- The South African Reserve Bank's (SARB) composite leading business cycle indicator rose by 3.7% in April to 125.8 from 121.4 in March, the most since last August, following an upwardly revised 2.2% increase in the prior month. The leading indicator leads economic activity by around six months and provides insight into expected future economic and business conditions. The recent improvement reflects, among other factors, the impact of the low base established a year earlier during the initial severe COVID-19 lockdown restrictions. Eight of the ten available component time series increased while the remaining two component time series decreased. The largest positive contributors were an acceleration in the 12-month rate of increase in the composite leading business cycle indicator for South Africa's major trading partner countries and an improvement in the RMB/BER Business Confidence Index. The detractors were a deceleration in the six-month smoothed growth rate in the real M1 money supply and a narrowing in the interest rate spread. Further ahead, the latest rounds of load shedding and the start of a third Covid-19 wave accompanied by more severe lockdowns will certainly have a negative impact on business conditions and business confidence in the months to come.

- Consumer Price Inflation: Annual headline inflation increased above the 4.5% midpoint of the South African Reserve Bank's (SARB) target range, climbing to 5.2% in May from 4.4% in April. This is the highest reading since November 2018, although in line with market expectations. The main contributors to the May 2021 inflation rate were food and non-alcoholic beverages, housing and utilities, transport, and miscellaneous goods and services. The acceleration in price growth was partly due to so-called "base effect", created by historically low oil prices at the height of global lockdowns in 2020. Core inflation, which is headline CPI excluding food and non-alcoholic beverages, fuel, and energy, measured 3.1% year-on-year in May, marginally up from 3% in April. This underscored the large impact fuel and food prices have on the overall inflation figures. Further ahead, inflation is expected to stay within the SARB's 3%-6% target range regardless of the recent spike in May. The majority of economists also expect the SARB to keep interest rates unchanged for the remainder of the year, despite the quick rise in global inflation (led by the USA) and a more hawkish stance from the US Fed in their meeting last week.

- Factory-gate prices jumped to a 48-month high in May, slightly above market expectations. Annual producer price inflation (PPI) increased to 7.4% in May 2021, up from 6.7% in April 2021. The producer price index increased by 0.4% month-on-month. The main contributors to the headline PPI rate were coke, petroleum, chemical, rubber, and plastic products; food products, beverages, and tobacco products; and metals, machinery, equipment, and computing equipment. Prices for intermediate factory goods increased by a robust 15.2% year-on-year. Among other producers, annual inflation was very high for mining products (21.7% year-on-year), while utility prices also rose by a considerable 8.9%. In the near term, both mining and utilities inflation could accelerate further amid a surge in global commodity prices and local electricity tariffs.

- The FNB/BER Consumer Confidence Index (CCI) declined in the second quarter of 2021 to -13 down from -9 in the first quarter. The latest reading lags the long-term average of +2 experienced since 1994. The second-quarter reading although negative is still a significant improvement from the extraordinary pessimistic readings recorded during the second and third quarter of 2020 at the height of the severe Covid-19 lockdowns. From a household income perspective, low-income households saw the biggest drop in confidence mainly due to negative events including rising food and fuel prices, the start of a third Covid-19 wave, a subdued recovery in low skilled employment opportunities and the expiration of Covid-relief payments in the form of social grant top-ups, the Social Relief of Distress (SRD) grant and the TERS program. In contrast, middle- and high-income consumers are less pessimistic about the future of their household finances, although they are more concerned compared to the first quarter about the economic prospects of the general economy. In summary, the decline in consumer confidence during the second quarter points to a lower willingness to spend among consumers and will likely translate into slower growth in overall consumer spending compared to the impressive first-quarter growth rate noted Matikinca-Ngwenya FNB Chief Economist. Further ahead, the sales of non-durable goods are expected to come under pressure on the back of a significant deterioration in the household finances of low-income consumers, who normally spend most of their household income on food and necessities. In contrast, durable and semi-durable goods sales volumes are being supported by pent-up demand from high- and middle-income consumers, who reduced their debt in 2020 on the back of record-low interest rates, accumulated savings, and tax benefits announced in the February national budget.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Leana Kruger

- Private Sector Credit Extension, due Wednesday 30 June. Private sector credit extension (PSCE) is expected to have remained in contractionary territory during May. The anticipated decline of 0.9% will nonetheless be an improvement from the steep 1.8% year-on-year decline recorded in April. The improvement from April is, however, expected as May saw a recovery in mortgage demand and vehicle sales, benefitting from low-interest rates and an uptick in disposable income.

- Balance of Trade, due Wednesday 30 June. The May trade balance is forecast to be in surplus by R46.2 billion surplus compared with a R51.2 billion surplus in April, helped by continued strength in key export commodity prices.

- BER/ABSA Manufacturing Purchasing Managers' Index, due Thursday 1 July. With the return of stage 4 load-shedding, the manufacturing purchasing managers' index (PMI) is likely to have weakened slightly in June despite healthy global demand and strong commodity prices. The consensus forecast is that the PMI declined to 56, down from 61.2 recorded in May.

- Total New Vehicle Sales, due Thursday 1 July. With the statistical distortion from the Covid disruption out of the way, new vehicle sales data are expected to have normalised in June. Sales are forecast to have grown in May by 26.4% year-on-year compared with a 197.8% increase in May.

NORTH AMERICA

Contributed by Nick Downing

- A week after the Federal Reserve's policy meeting at which it signalled the start of discussions on tapering its monthly asset purchase programme, Chairman Jay Powell offered reassurance in his Congressional testimony that the central bank would adopt a patient approach. The reassurances prompted the S&P 500 index to chalk up a new record high. Quizzed by both parties on the inflationary threat, Powell explained that price increases tended to be in "areas that are directly affected by the reopening" and therefore would likely be temporary. He started his testimony by stating that the Fed would continue to "support the economy for as long as it takes to complete the recovery" and later cautioned that the pandemic remained a risk to the economic recovery due to a slowdown in vaccination rates and the emergence of new Covid variants. Meanwhile, the Fed's stress tests on the largest banks' capital adequacy showed a clean bill of health. In a scenario of seven straight quarters of declining GDP, unemployment exceeding 10% and a 55% drop in the US equity market, the banks' capital ratios would drop to 10.6% but this is more than double the required minimum. The strong result means the Fed will withdraw all remaining restrictions on bank dividend payments and share buybacks, a likely catalyst for a continued re-rating of the bank sector.

- President Biden achieved breakthrough bipartisan support for his infrastructure stimulus plan, providing an additional boost to US equities. Although less than the originally envisaged $2.3 trillion the agreement amounts to a sizeable $1.2 trillion over 8 years. A portion relates to existing spending plans, with the residual $579 billion relating to new spending. The funding of the plan avoids any tax increases, a key selling point for Republican support, coming instead from unspent money from previous stimulus measures, greater tax enforcement and sales from the Strategic Petroleum Reserve. However, the agreement is a long way from being ratified by Congress. Before committing its support to the infrastructure plan, progressive Democrats in the House of Representatives will likely want to see progress on Biden's $1.8 trillion American Families Plan, which is more contentious due to its reliance on tax increases and emphasis on social spending.

- Personal income fell in May by a sizeable 2% month-on-month, underscoring concerns that the fading effect of once-off stimulus cheques and enhanced unemployment benefits may slow the pace of the economic recovery. After all, consumer spending accounts for over two-thirds of US GDP. However, the consumer remains in rude health. Helped by fiscal rescue programmes, precautionary savings and forced savings due to lockdowns, as well as soaring equity and residential property markets, US household wealth surged in 2020 by an astonishing $13.5 trillion, the biggest increase in decades and more unusually, coinciding with a steep albeit short recession. The savings ratio declined from 14.5% in April to 12.4% in May, as consumers are increasingly able to spend on services which are reopening, but the savings rate is still elevated compared to its long-term average of 5-7%. Excess savings, estimated at over $2 trillion, combined with the tailwind of rising equity and property markets bode well for household expenditure, the main pillar of the economy. The median existing home price topped $350,000 in May for the first time, equivalent to an annual increase of almost 24%.

JAPAN

Contributed by Carel la Cock

- Japan's private sector business activity continued to decline in June following a similarly disappointing survey result in May. The latest Jibun Bank Flash Japan Composite Purchasing Manager's Index (PMI) reading of 47.8 in June was down one point from May, indicating a steeper deterioration in private sector business activity. The Manufacturing Purchasing Manager's Index showed that the sector expanded at a slower rate in June with a reading of 51.5, slipping from 53.0 in May and marking the worse reading in four months. Output fell for the first time since January and new order growth also weakened. Survey participants attributed the weakening to ongoing covid-19 restrictions, compounded by supply chain pressure. The services sector saw another monthly decline (sub 50 reading), although at a slower pace. The Services Business Activity Index improved to 47.2 in June from 46.5 in May, however new business declined for a 17th consecutive month. On a positive note, both manufacturers and service providers employed additional staff while optimism for business conditions in the year ahead improved overall, and especially so in the services sector, as more restrictions are lifted following expanding vaccination rollouts.

EUROPE

Contributed by Carel la Cock

- In Europe, private sector business activity is expanding at a rate not seen in 15 years. The IHS Markit Flash Eurozone Composite PMI paints an encouraging recovery picture, leaping from 57.1 in May to 59.2 in June, driven by a further relaxation of covid-19 restrictions across the region. Demand rebounded strongly in the month as new order growth accelerated at the fastest pace in more than a decade and a half. Manufacturing continues to lead the recovery, recording the twelfth monthly expansion in output. The Flash Eurozone Manufacturing PMI Output Index at 62.4 marked a two-month peak with the rate of expansion only slightly below the record set in March. Germany reported the strongest increase in production growth, while France lagged the pace of new order growth for the region. The services sector continued to rebound strongly as travel restrictions are lifted amid accelerating vaccinations. The Flash Eurozone Services PMI Activity Index hit a 41-month high at 58.0 in June, up 2.8 points from May. Both manufacturers and service providers expanded staff compliments for a fifth consecutive month in anticipation of a brightening outlook, but work backlogs accumulated to record levels despite the increased manpower. Supply shortages for manufacturing inputs were also widespread leading to lengthening supply chains while producers continued to run down inventories of completed stocks. The surge in demand outstripped supply for goods and services and have added to inflationary pressure. Input prices on average rose at a pace only seen once in 23 years, driven by higher fuel and transport costs as well as rising wages. Rising costs were passed on to consumers and prices charged for goods and services rose at the fastest pace in two decades adding to the inflationary pressure felt across developed markets.

UNITED KINGDOM

Contributed by Carel la Cock

- The UK experienced another strong month of output growth in the private sector, only easing off marginally from the record pace set in May. The IHS Markit/CIPS Flash UK Composite

Output Index at 61.7 showed that output in the private sector continued to grow at historic levels as the economy rebounds following one of the most successful vaccination campaigns in the developed world. New orders rose sharply, and companies responded by hiring more staff in both manufacturing and services with the rate of job creation now the fastest since the survey began. Input prices continued to rise in manufacturing, but also saw a marked increase in the services sector, leading output price inflation to hit another record for a second consecutive month. Chief business economist at IHS Markit, Chris Williamson warns, "inflation worries have continued to intensify. Record levels of the survey's price gauges and the further development of capacity constraints hint strongly that consumer price inflation has much further to rise after already breaching the Bank of England's 2% target in May. The survey also found growing evidence of labour shortages feeding through to higher wage costs, which could add to worries that the recent spike in inflation could prove stickier."

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 10.77	65809
JSE Fini 15	+ 6.05	12789
JSE Indi 25	+ 10.99	86459
JSE Resi 20	+ 10.47	63603
R/$	+ 3.04	14.26
R/€	+ 5.57	17.00
R/£	+ 1.45	19.79
Dow Jones	+ 12.51	34433
Nikkei	+ 5.84	29048
Hang Seng	+ 7.48	29268
FTSE 100	+ 9.48	7072
Gold	- 5.95	1781
Platinum	+ 4.31	1116
Brent oil	+ 49.3	72.43

BOTTOM LINE

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- There is no doubt that the economy is recovering. In the first quarter (Q1), GDP beat expectations with growth of 4.6% quarter-on-quarter annualised, slowing from 5.8% in Q4 2020 but far better than the Reserve Bank's 2.7% forecast. Forward-looking survey data, coupled with strong export performance, driven by the mining sector and vehicle sales, point to economic momentum being maintained in Q2. The RMB/BER Business Confidence Index jumped from 15 to 50 in Q2. The number of survey respondents satisfied with business conditions now equals those that are not satisfied, an outcome we have not seen in years. The RMB/BER Retail Survey Index surged from 37 to 54, with confidence in the durable goods sectors especially strong, helped by record low interest rates. New vehicle dealer confidence increased from 35 to 63. The Absa manufacturing purchasing managers' index (PMI) increased to 57.8 in May, consistent with strong manufacturing activity over coming months. The IHS Markit PMI, measuring activity across the entire economy, is also well above the expansionary 50-level, printing 53.2 in May.

- The South African Reserve Bank lifted its 2021 GDP growth forecast from 3.8% to 4.2%. Some economists believe growth of up to 5% could be achieved, but most question the sustainability of these upbeat growth rates. According to the SARB's longer-term forecasts, GDP growth will slow to 2.3% in 2022 and 2.4% in 2023. The current growth spurt is cyclical rather than structural, attributed to the restocking of inventories, which were depleted during the height of the Covid pandemic, and to the surge in global trade and commodity prices. The SARB's latest composite leading business cycle indicator recorded a new multi-year high of 121.3, registering a year-on-year increase of 18.1%. Yet beside the obvious base effect of rock bottom comparative figures last year, the biggest contributors to this sizeable increase were gains in the leading indicators of South Africa's trading partners and in the US dollar-denominated export commodity price index. These represent external influences. Domestically focused measures such as money supply growth, the number of building plan approvals and job advertisements were negative contributors.

- Our recent economic success stems predominantly from the "V" shaped recovery in the global economy, not from any structural improvements of our own. The trade surplus is surging, measuring R147.8 billion in the year to end April. In the same period last year, the trade balance showed a deficit of R4.4 billion. Exports increased 213% year-on-year while imports increased by just 25.8%. The figures contributed to a R69 billion widening in the current account surplus in Q1 to R267 billion, rising from 3.7% of GDP to 5%. This is impressive and certainly the unexpected boost to our fiscus from commodity exports is a relief. Thanks in large part to a windfall from strong commodity exports, South Africa's main budget deficit for the last fiscal year came in at 11.2% of GDP, much lower than the earlier projection of 14%. We cannot escape the fact though that the surging trade surplus is also testament to acute weakness in domestic demand. Despite the strong headline GDP figure, gross fixed capital formation actually contracted in Q1. Household consumption expenditure strengthened by 4.7% but it is hard to envisage positive momentum amid shrinking private sector credit extension and a chronically depressed jobs market. Credit extension contracted year-on-year in April for a second straight month.

- The unemployment situation is dire. The official unemployment rate increased to 32.6% in Q1 from 32.5% the prior quarter. The broader definition of unemployment, which includes those who are discouraged and given up looking for work, increased from 42.6% to 43.2%. The official unemployment rate among younger South Africans between the ages of 15-34 is an astonishing 46.3%, presenting an enormous risk to social stability. The risk is compounded by the rapid deterioration in public service provision and the financial stability of municipalities. In a worrying report, Ratings Afrika published a further decline to new record lows in the financial stability of the country's municipalities and metros, which on average are well below the deemed level of financial viability.

- The credit rating agencies have kept South Africa's sovereign debt at three levels below investment grade. While listing the country's strengths, which include a credible central bank, a flexible exchange rate, actively traded currency and deep capital markets, the rating agencies cited the lack of structural economic reforms as a key risk. The good news is that President Ramaphosa, through Operation Vulindlela, a joint operation between the Presidency and the National Treasury, is finally taking action. In the space of two days, coinciding with Ramaphosa's attendance at the G7 meeting in the UK, the government announced that the licensing threshold for private sector electricity generation would be raised from 1 megawatt to 100 megawatts, and that South African Airways would be partly privatised with the sale of a 51% stake to the Takatso Consortium. These moves caught the public by surprise, which understandably has become increasingly jaded. Ramaphosa has increased his authority within governing circles, driving the opposing "Radical Economic Transformation" factions further into touch following the ANC's formal suspension of Secretary General Ace Magashule. We are hopeful that these recent initiatives will be the start of a concerted structural reform drive rather than ad hoc measures taken out of desperation. As the proverb goes "One swallow does not a summer make."

- Inflation has picked up. Consumer price inflation (CPI) accelerated in April to 5.2% year-on-year but with an absence of demand pressure and enormous slack in the economy and labour markets, there is not the same fear of rising inflation expectations as exists in the rest of the world. On a month-on-month basis, CPI increased by a very mild 0.1%. The SARB has reduced its 2021 CPI forecast from 4.3% to 4.2%, leaving it unchanged for 2022 and 2023 at 4.4% and 4.5%, comfortably tracking the midpoint of its 3-6% target range. With a strong and stable rand, underpinned by buoyant commodity prices and robust terms of trade, coupled with high long-term interest rates (amongst the highest bond yields in the world), any SARB interest rate hikes are likely to be gradual and mild.

- Notwithstanding the 14-day adjusted Level 4 lockdown imposed on 27th June, the short-to medium-term outlook is positive. Low interests, a stable rand and an ultra-accommodative monetary policy at the Federal Reserve and other major central banks, are a constructive combination for outperformance by emerging markets. The JSE, with its heavy weighting in resource stocks, is no exception and should continue to perform well on a 12-month horizon, helped by expectations of a strong cyclical recovery over the period. However, over the longer-term, portfolios should maintain a healthy exposure to rand hedge investments and overseas markets, until there is more definitive evidence that the summer of structural economic reform has indeed arrived.

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