OVERBERG MARKET REPORT

Tuesday 17th August 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- Global equity markets have treated investors excessively well over the past 15 months since hitting pandemic lows on 20th March 2020. Fueled by unprecedented monetary and fiscal support, and rapid development of effective Covid vaccines, equity markets worldwide have surged, in many cases to significant record highs. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Ingrid Breed

- Manufacturing production increased 12.5% in June 2021 compared with June 2020. This figure was slightly above the consensus forecast of 11.25% year-on-year growth with the positive annual growth being largely the result of low base effects as the country slowly came out of the hard lockdown a year ago. Overall manufacturing production has remained below pre-pandemic levels with output contracting for the third month in June, recording a 0.7% contraction from May to June 2021. The largest contributions to manufacturing production were made by the following divisions: motor vehicles, parts and accessories and other transport equipment (up 84.1%); basic iron and steel, non-ferrous metal products, metal products and machinery (up 19.2%); wood and wood products, paper, publishing and printing (up 22.8%); food and beverages (up 5.9%); and furniture and 'other' manufacturing (up 73.5%). Seasonally adjusted manufacturing production decreased 1.0% in the second quarter of 2021 compared with the first quarter of 2021. Looking ahead, despite the lockdown restrictions and looting, which are expected to weigh heavily on manufacturing production in July, manufacturing activity is expected to return to growth in the second half of the year as global demand, commodity prices and domestic spending continue to increase.

- After recording a more than three-year high of 97 in May the South African Chamber of Commerce and Industry's (SACCI's) Business Confidence Index (BCI) dipped slightly by 0.8 index points to 96.2 in June and fell further by three index points to 93.2 in July. This plunge in confidence reflects the negative impact that civil unrest had on businesses. "The spate of looting and destruction during July in certain areas of South Africa, whatever the intention, was a setback to inclusivity, growth and job creation," SACCI said while remarking that even though this is a short-term decline it could compound and negatively influence investor confidence over the longer term. Despite the dip in business confidence, the decline was less severe than the consensus forecast that indices would drop to 96 and 90 respectively in June and July. Furthermore, notwithstanding the negative influence that the arrest of former president Jacob Zuma had on looting, the adherence to the rule of law would have sent a positive signal to the business community.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- Consumer Price Inflation for June, due Wednesday 18 August. The Consumer price inflation (CPI) rate is expected to have eased further in July on an annual basis from the two-and-a-half-year high of 5.2% recorded in May. Despite this annual easing of CPI, the monthly figure is likely to record a sharp increase as July saw an increase in Eskom's annual tariff, the annual increase in water and other municipal rates and a higher petrol price. The consensus forecast is that CPI was 4.7% year-on-year and 1.2% month-on-month in July from 4.9% year-on-year and 1.2% month-on-month in June. Core CPI, which excludes volatile items such as food and non-alcoholic beverages, fuel and energy, is expected to have remained stable at 3.2% year-on-year.

- Retail Sales, due Wednesday 18 August. As the impact of 2020's lockdown related base effect starts to fade, July is expected to have recorded a more moderated 9.4% year-on-year increase in retail sales (down from 15.8% in May) and a 0.5% month-on-month contraction (down from 2.1% growth in May). In August, retail sales performance is expected to have been impacted by level 4 lockdown restrictions and the after-effects of July's civil unrest.

NORTH AMERICA

Contributed by Nick Downing

- The most closely watched macro-economic variable in today's markets is inflation. While the Federal Reserve and most economists believe the current spike is "transitory" and will ease once supply chains and reopening distortions fade, other economists believe inflation will stick at higher levels of around 3%. This would compare with the Fed's average inflation target of 2%. Consumer price inflation (CPI) remained unchanged from the previous month in July at 5.4% year-on-year, but the month-on-month rate dropped from 0.9% to 0.5%. Core CPI, excluding food and energy prices, fell from 4.5% to 4.3% on the year and from 0.8% to 0.3% on the month. It appears that inflation has peaked. For instance, used car prices which increased 10.5% on the month in June and 7.3% in May, and cited as one of the key culprits in the current inflation spike, slowed in July with a gain of just 0.2%. Negative base effects should lead to a decline in inflation readings over coming months. The expiry of Covid relief measures, a natural exhaustion of pent-up demand and reduced supply chain constraints will contribute to falling inflation. However, the jury will have to wait until the temporary distortions of the past year have been fully unwound before deciding on the longer-term stickiness of higher inflation. In the meantime, rent inflation merits scrutiny. Rent has started picking up and could rise even further in line with the surge in residential property prices. Rent and owners' equivalent rent increased in July by 0.2% and 0.3% on the month, equal to June's gains. Rent comprises 40% of the core CPI basket and historically has tended to exhibit long-lasting cycles.

- The stronger than expected July jobs report, which showed the US added 943,000 non-farm payrolls, has increased market expectations that the Federal Reserve will soon begin to taper its monthly asset purchase programme. Following the payroll report the jobs deficit, compared with the pre-pandemic employment level, fell from 6.6 million to 5.7 million. Meanwhile, job openings have increased to 10.1 million, the highest level on record and more than enough to absorb the remaining jobs deficit. The Fed has repeatedly stated that it would continue its $120 billion monthly purchases of Treasury bond and mortgage-backed securities until it achieved "substantial further progress" on its twin objectives of 2% average inflation and maximum employment. The inflation target has been achieved and at the current rate of jobs growth, the employment target should be met by the end of the year. Most Fed policy makers are taking the view that October's nonfarm payroll report, to be released in November ahead of the November Fed policy meeting, will provide the trigger for a tapering decision. Some Fed governors are arguing for a more imminent taper decision but the heavyweights within the central bank including Fed chairman Jerome Powell, are more dovish. Their added caution, premised on the unknown effects of the Covid Delta variant and of expired Covid relief benefits, is likely to prevail, which would mean the earliest any taper decision could be taken is at the policy meeting on 2-3rd November.

- The rapid spread of the Covid Delta variant has sparked a sharp decline in consumer confidence. The University of Michigan US consumer sentiment index slumped in August from a July reading of 81.2 to 70.2, below the lows reached in April 2020. The decline, the steepest since April 2008 at the height of the Global Financial Crisis, takes the index to its lowest level since December 2021. Consumers' expectations and their assessment of current conditions were equally depressed, the first falling from 70 to 65.2 and the latter from 84.5 to 77.9. There was also a whiff of stagflation in the survey data. Stagflation is characterised by rising inflation in conjunction with slumping economic activity. In the survey, household expectations for annual inflation over the next 5 years increased from 2.8% to 3%. According to the survey report, "Consumers have correctly reasoned that the economy's performance will be diminished over the next several months, but the extraordinary surge in negative economic assessments also reflects an emotional response, mainly from dashed hopes that the pandemic would end soon."

CHINA

Contributed by Nick Downing

- China suffered a sharp decline in economic momentum in July, attributed to a wave of Covid Delta variant infections, extreme weather conditions and flooding in the central region and falling export demand. Growth in industrial production slipped from 8.3% year-on-year in June to 6.4%. Retail sales growth dropped from 12.1% to 8.5% on the year. In the January-July period fixed asset investment fell to 10.3% on the year down from 12.6% in the January-June period, while over the equivalent periods, property investment dropped from 15% to 12.7%. Although nationwide Covid infections are muted at around 100 per day, authorities are sticking to their zero-tolerance policy with mass testing and travel bans having a pronounced impact on economic activity. Meanwhile changing consumer patterns in export markets, with household expenditure moving from manufactured goods to services, caused export growth to slow from 32% in June to 19% on the year in July. At the same time, authorities have escalated their regulatory crackdown on certain economic sectors, prompting severe job losses in the education sector. In the past week, the government launched a 5-year plan to strengthen regulatory control over key sectors including technology, education and healthcare, which could further dampen business and consumer confidence. Goldman Sachs has reduced its third quarter GDP growth forecast from 5.8% quarter-on-quarter to 2.3%. However, it forecasts growth to stabilise rapidly once the latest Covid wave is brought under control, with the full year GDP forecast reduced more modestly from 8.6% to 8.3%, which is still well above the government's 6% target.

JAPAN

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- Japan's economy rebounded in the second quarter of the year and beat expectations but was behind the pace of other developed economies. Quarter on quarter growth of 0.3% or 1.3% annualised was ahead of the 0.7% expected by analysts and recovered some lost ground following the 0.9% contraction in the first quarter. Private consumption grew by 0.8% quarter on quarter partly offsetting the 1.0% contraction in the first quarter while exports and business investments also made meaningful contributions, growing by 2.9% and 1.7% compared to the previous quarter. Despite the better-than-expected recovery, economists are pessimistic on third quarter growth, citing the minimal impact of an Olympic games held behind closed doors and the tripling of new covid-19 cases in recent weeks leading to renewed lockdown measures in Tokyo and other major cities. Vaccinations have gathered pace and fewer hospitalisations have been observed with the Delta variant, but analysts remark that confidence in the economy will in all likeliness only return in the fourth quarter of the year. Goldman Sachs forecasts that pent-up demand, once the effectiveness of the vaccines becomes apparent, will drive a sharp recovery in the fourth quarter with growth of 8.4% expected.

EUROPE

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- Germany's industrial production continues to be hampered by supply-chain bottlenecks, suffering another month-on-month contraction in June, with a drop of 1.3% following a 0.8 contraction in May. Production levels are 6.8% lower than February 2020, before covid-19 restrictions were implemented. Within the various categories of production, consumer goods grew 3.4% and intermediary goods by 0.9%, but the production of capital goods fell 2.9% while production in construction was down 2.6%. The shortage of semiconductors remains a major headwind for car manufacturers and production was down 0.9% month on month and nearly a third lower than pre-pandemic. Carmakers have lowered their expected output for the year by 400,000 units, citing the shortage of semiconductors as the main cause and forecasting that it could persist in the medium term. Despite concerted efforts by Europe to increase its production capacity for semiconductors, it will be some time before supply will meet demand. Economists forecast that supply constraints will continue to detract from the economic recovery in Germany in the second half of the year and cast doubt over a full recovery to pre-pandemic levels by the end of this year.

UNITED KINGDOM

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- The UK economy expanded at the fastest pace amongst G7 countries in the second quarter although it still lags most advanced economies in making a full recovery to pre-pandemic levels. Output grew by 4.8% quarter on quarter, narrowly missing the Bank of England's 5% forecast and falling 4.4% below the economic output at the end of 2019. Consumer spending grew 7.3% in the quarter and was boosted by the easing in lockdown measures which led consumers to flock to restaurants and pubs and increased hotel stays and transport. A fall of 0.5% in government capital expenditure was offset by business investment rising 2.4%. Preliminary numbers for June indicate a 1% month on month growth following growth of 0.6% in May, but economists have warned that the Delta variant has probably stemmed the momentum as many workers had to self-isolate as covid-19 cases surged in July. However, the economy is likely to make up lost ground and recover to pre-pandemic levels by October, according to a forecast by Capital Economics and will likely emerge "from the pandemic without much scarring."

FAR EAST & EMERGING MARKETS

Contributed by Carel la Cock

- When the United States announced the withdrawal of their troops from Afghanistan, there was always a likelihood that the US sponsored Afghan government would eventually be overrun by the Taliban, but few would have a wagered a bet that it would happen within two weeks. Over the weekend the Taliban seized control of the capital, Kabul, and the US backed government collapsed sending President Ashraf Ghani into exile. Scenes of hundreds of people crammed on US military planes made headlines around the globe as most journalists feared the worst. Until now the Taliban has taken a more moderate approach than when they ruled in the late '90s, even offering amnesty to US interpreters. However, the region has become more unstable and bond investors are withdrawing funds from the region. Pakistan has seen yields on its dollar bonds rise by 1% with the 10-year bond now yielding 7.3%. It is expected that Pakistan will have to deal with many refugees from Afghanistan while also possibly shouldering sanctions for working with the Taliban. Other nations in the surrounding area such as Uzbekistan have also seen a spike in bond yields. The international community is watching in angst as the Taliban take control of Afghanistan and hope that many of the liberties afforded to its citizens under US occupation, are not reduced to ashes.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 15.85	68824
JSE Fini 15	+ 14.32	13787
JSE Indi 25	+ 11.69	87006
JSE Resi 20	+ 19.95	69063
R/$	+ 1.39	14.90
R/€	- 2.34	17.54
R/£	+ 2.49	20.60
Dow Jones	+ 16.40	35625
Nikkei	+ 0.24	27510
Hang Seng	- 4.88	25901
Shanghai	+ 0.27	3482
FTSE 100	+ 10.73	7154
Gold	- 5.83	1787

Platinum	- 4.27	1026
Brent oil	+ 34.21	69.52

BOTTOM LINE

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- The outlook for the global economy is bright. Even after monetary policy starts to normalise and fiscal stimulus is gently removed, economic growth is likely to subside to a much stronger trend growth rate than we were accustomed to in the decade which followed the 2008/09 Global Financial Crisis. The 2010s were marked by a painful deleveraging process across developed economies. Banks, households and businesses were all affected. The situation now is vastly different. Following years of repair, bank balance sheets are robust, and households enjoy substantial household savings. There is scope for credit expansion rather than credit contraction, and companies are more willing and able to invest.

- There are ample reasons to feel confident about the next decade. However, much has already been discounted in equity markets. The sugar high from ultra-accommodative monetary policy and Covid relief handouts is all too plain to see in excessive market valuations. TINA is an acronym for the phrase “There Is No Alternative”. With interest rates so low and bond yields earning negative real returns (after adjusting for inflation), equities remain a compelling alternative with dividend yields in many cases above bond yields. As central banks are committed to keeping interest rates at the zero bound for some time to come, the TINA trade is alive and well, but investors also need to closely examine RISK, which is the other side of the ledger. Due to excessive valuations, risk levels are flashing Red.

- Some of the charts are scary, particularly if you suffer from vertigo. Although the valuation of some markets is less stretched, including emerging markets, Japan and UK, all markets are expensive, in particular the US. The US market deserves close attention. It comprises 60% of the MSCI World Index and as the adage goes, “when America sneezes, the world catches a cold.” US valuation indicators are in most cases at the same peak levels that preceded the dotcom bubble, which burst at the turn of the millennium. The Tobin Q (measuring the market value versus replacement cost), the Shiller CAPE (cyclically adjusted price-to-earnings ratio) and price-to-book ratio are all at the same level as in 2000, in other words equal to the record high. The stock market capitalization-to-GDP ratio is off the scales at 2.0 well above the year 2000 level of 1.5. Investment guru Warren Buffett, the sage of Omaha, doesn't get excited about making investments unless the value-to-GDP is less than 1.0.

- Technical and sentiment indicators are also emitting warning signals. The value of share portfolios comprises a higher proportion of US household wealth than ever before. The exuberance for new investment fads is also a red flag. For example, the insatiable appetite for crypto-currencies and for initial public offerings (listings) of companies that are yet to make a profit. A new phenomenon is the SPAC (special purpose acquisition vehicle), which only has cash upon listing and often trades at multiples of its cash value before even making a single acquisition.

- Contrary to conventional wisdom, the time of greatest risk in equity markets is not after a massive sell-off, correction or a stock market crash but before the event when valuations are at their peak. Once markets have lost ground, risk levels are diminished. Although contrary to the optimism currently pervading markets, which are clocking-up successive record highs on an almost daily basis, it is wise to lock-in some of the market's gains. This can involve either taking profits or implementing a milder rebalancing of portfolios. Where the opportunity arises, it may be a good time to prune weaker holdings or those that have made outsized gains and no longer offer value. A disciplined proactive approach is far better than a reactive approach, which may often result in a knee-jerk response to market declines and the sale of shares after steep declines, when in fact one should rather be buying at this point. Keeping ahead of the curve with an active management process allows for the gradual accumulation of a healthy cash balance before a steep market decline.

- In the current environment, investors may be well advised to raise cash levels at a moderate pace, which can be used to buy shares at cheaper prices once valuations revert to their longer-term average. However, cash returns in developed markets are almost non-existent and cash can be a drag on performance. An option is therefore to invest a portion of the proceeds from equity sales into safer alternative asset classes, which are less volatile than equity markets or in some cases offer negative correlation to equities and therefore provide excellent risk diversification. Some of these alternative asset classes such as infrastructure, renewable energy, real estate investment trusts and credit products have the added advantage of offering attractive income yields. Another option, probably best suited to investment portfolios with a more aggressive growth mandate is to recycle profits into other equity markets and sectors, which are cheap by comparison and offer better risk/return opportunities.

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