## OVERBERG MARKET REPORT

Tuesday 12th October 2021

### IN THIS WEEK'S BOTTOM LINE

*Contributed by Nick Downing*

- The JSE weakened during the third quarter (Q3) in line with global markets, which came under pressure from a resurgence of Covid infections, a gradual withdrawal of pandemic-era stimulus and a slowing in the pace of economic growth.

### SOUTH AFRICA ECONOMIC REVIEW

*Contributed by Gielie Fourie*

- The IHS Markit South Africa PMI (Purchasing Managers' Index) increased to 50.7 in September, up from 49.9 in August. Any figure greater than 50.0 indicates an overall improvement in the sector. The 0.8 move may be marginal, but it is moving in the right direction. It was above the crucial 50.0 mark for the first time in three months. In previous months lockdown measures and unrest led to steep declines in production, triggering supply shortages. The easing of lockdown measures to Level 2, did much to push the private sector back into growth territory in September. Output and new orders increased in September, but production was hindered by supply shortages. In addition, higher backlogs, longer delivery times and increased prices, further slowed down output. Orders from foreign clients fell for the fourth month running. Firms had to wait longer for imports of raw materials. Supply chain issues will continue to hinder the economic recovery for some time, unfortunately. On a positive note, business expectations for the coming year jumped to their strongest level since July 2015, a clear signal that firms are looking past current supply chain issues. This is just what business needed. Despite the spectre of supply chain shortages, firms believe the economy will continue to recover. Firms are projecting a robust upturn in activity. This improvement at the end of the third quarter is most welcome. The outlook for the fourth quarter is looking promising indeed.

### SOUTH AFRICA: THE WEEK AHEAD

*Contributed by Ingrid Breed*

- Mining Production, due Tuesday 12 October. Mining activity is expected to have expanded for a sixth consecutive month, reflecting the gradual recovery from the 2020 Covid-19 shock. The recovery momentum is, however, expected to have softened after a strong run, due to fading base effects. The consensus forecast is that mining production increased around 6% year-on-year and 5% month-on-month in August from 10.3% and 4.1% in July.

- Manufacturing Production, due Tuesday 12 October. Factory activity is expected to have rebounded in August after July recorded the first decline after four consecutive months of expansion, consistent with the recovery recorded in the manufacturing purchasing managers' index. The consensus is that manufacturing activity grew 3.3% year-on-year and 8.9% month-on-month in August from the respective 4.1% and 8% declines in July.

- Retail Sales, due Wednesday 13 October. After being negatively influenced by the civil unrest and lockdown restrictions during July, the August retail sales figures are expected to indicate an improvement within the sector. The consensus forecast is that retail sales rose 2% year-on-year compared with the 0.8% contraction in July.

**GLOBAL**

***Contributed by Nick Downing***

- Port congestion and surging shipping costs have made a sizeable contribution to supply chain disruptions and rising inflationary pressures over recent months. There are indications that the worst may be over. The cost of shipping goods from China to the US has halved over the past 6 weeks. It may well be that volumes have declined but there is also evidence that port congestion is being cleared, according to the number of waiting container ships in key ports, in both China and the US. This is good news for producers. In its most recent report, published last week, the World Trade Organisation said it expects global freight bottlenecks to ease in coming months, which should relieve cost pressures at the producer level. In the same report, the WTO provided encouraging insight into the role of global trade in a post-pandemic world. Contrary to earlier expectations, that the pandemic would prompt onshoring of supply chains, the WTO said global trade would continue to grow in line with world GDP and that there would be no discernible on globalisation. According to its forecasts, the robust recovery in global trade volumes felt over the past year would continue into 2022, with Asian economies enjoying the strongest growth, and Vietnam leading the way over 5 years. Vietnam is expected to grow its annual exports in real terms by 13% annually.

- The oil price has surged by 120% over the past 12 months pushing Brent crude to $83 a barrel, its highest level since 2014. An acute energy shortage in Asia and in Europe, where the natural gas price has increased fivefold over the past year, is exacerbating the oil price squeeze. Meanwhile the Opec+ group has resisted pressure from the US to increase supply beyond its agreement earlier in the year to lift production by monthly instalments of 400,000 barrels per day. Opec+ blames the price spike on a lack of investment in new supply, highlighting the dangers of transitioning to carbon-free energy too quickly. Economists fear the oil price could continue rising, in turn lifting inflationary pressures while at the same time curbing consumer and investment activity. Seen as a tax on household consumption, oil price spikes frequently precede economic recessions, depending on the extent and sustainability of the oil price move. Central bank policy will be put in a quandary. On the one hand rising energy prices are inflationary but at the same time they will choke the economy and employment growth. The Federal Reserve has a dual mandate to keep inflation within target but also to maximise employment.

## NORTH AMERICA

*Contributed by Nick Downing*

- The number of new jobs created in September fell well below expectations. Nonfarm payrolls only increased by 194,000, down sharply from 366,000 in August and the lowest since December 2020. The year-to-date monthly average is 561,000 and the consensus forecast was 500,000. The disappointing data is partly attributed to the Covid Delta variant, which caused job seekers to stay at home. For the first time since January, there was a monthly increase in the number who cited the pandemic as the reason not to look for a job. The number increased by 107,000 on the month to 1.6 million. The labour participation rate, counting the number either employed or actively seeking employment, was unchanged at 61.6% close to where it has remained since lockdowns were first lifted last year, compared with 63.3% in February 2020. A low labour participation rate explains the unemployment rate dropping from 5.2% to 4.8%, despite there being 5 million fewer people employed than prior to the pandemic. Wages increased by a solid 0.6% month-on-month and by 4.6% year-on-year, indicating a tight labour market notwithstanding the disappointing jobs growth. The jobs report is unlikely to deter the Federal Reserve from formally announcing a taper of its asset purchase programme at the upcoming policy meeting on 2-3rd November. The worst of the delta variant effect is now over and with the thinning of accumulated Covid relief transfers, employment growth should pick-up momentum.

## CHINA

*Contributed by Nick Downing*

- The debt default by China Evergrande Group, the world's most indebted property developer, may be the tip of the iceberg. Since its technical default, luxury developer Fantasia Holdings Group has defaulted on 4th October on bonds valued at $206 million, and Modern land has requested permission to defer repaying a $250 million bond. Almost half of the 59 Chinese development companies in the ICE Asian bond index have bonds trading at yields above 20%. Around half of the country's biggest developers are in breach of at least one of the "Three Red Lines" leverage controls imposed last August. The limits were put in place to quell the unsustainable property boom. Authorities felt the multi-year boom was putting property prices out of reach for many households in addition to endangering financial instability. Property developers have amassed an estimated $5.2 trillion in debt. Property related debt, also including mortgage loans, make up almost a third of China's total bank loans. Beijing realises the property boom is unsustainable, due to excessive prices, excessive leverage and excess capacity. However, the combined property and construction industries make up 29% of economic activity, creating a headache for the government, which is anxious to maintain a 6% economic growth rate. Authorities will be under acute pressure to launch monetary and fiscal policy stimulus, resulting in increased infrastructure and fixed asset investment. Liquidity injections should boost equity markets. Domestic investors view residential property, which makes up an estimated 75% of all Chinese assets, as the main competing asset class to equites. With confidence in property under extreme pressure, there is good reason for equities to start outperforming.

## EUROPE

*Contributed by Carel la Cock*

- Business and consumer survey results in Europe remained stable in September after easing from the 10-year peak reached in July. The Economic Sentiment Indicator (ESI) for the euro area was up 0.2 points to 117.8, with a reading of 100 separating pessimism from optimism. Improving confidence in construction and among consumers were offset by lower confidence in services and retail trade. Industry confidence improved marginally in the euro area and remained at record levels. The ESI improved for Spain (+1.7), Germany (+0.8) and the Netherlands (+7.1) but deteriorated for France (-1.3) and Italy (-0.9). France saw worsening confidence in Industry (-1.7), Services (-2.8) and Retail Trade (-8.3) while Consumers (+3.3) and Construction (+1.1) provided some bright spots. A similar trend was reported in Italy. Importantly the Employment Expectations Indicator (EEI) increased to its highest level since the second half of 2018, reaching 113.6 points. The improvement was driven by employment plans in the services and construction industries, while retailers indicated a reduction in staff in the next three months. Unemployment expectations amongst consumers also improved significantly which is important for a consumer driven recovery. Furthermore, selling price expectations rose further in industry and retail trade, and hitting new record levels in services. Consumer price expectations also increased markedly in September and would be of concern to European Central Bank rate-setters who maintains that inflation is expected to be transitory. If rising inflation expectations become widespread it could become self-fulfilling leading to a rate hiking cycle sooner than expected.

## UNITED KINGDOM

*Contributed by Carel la Cock*

- Comments made by Bank of England's (BoE) Monetary Policy Committee (MPC) members over the weekend have driven up UK gilt yields to the highest levels since mid-2019. Andrew Bailey, governor of the BoE was quoted saying he was "concerned about inflation" and added that the BoE needs to prevent expectations of high inflation from setting in and causing a self-fulfilling inflation spiral. Michael Saunders, another MPC member, said in a separate interview that the market's expectation of an earlier rate hike was "appropriate". The markets responded on Monday by pricing in a 0.25% rate hike before the end of this year, with a further 0.5% in the first quarter lifting the benchmark rate from the current 0.1% to almost 1% by the end of next year. The market expects inflation to peak at 6% by the end of the first quarter and then level off to 3% and above the BoE's 2% target for an extended period. The 10-year gilt yield shot up from 0.5% barely two months ago to 1.21%. The spread between the German 10-year bond has widened to 1.33%, the widest since the EU referendum. Despite the higher yields, Sterling has weakened versus the Euro and analysts believe it is because of deteriorating Brexit talks. Recent comments regarding the Northern Ireland protocol have some analysts fearing an all-out trade war with both parties calling the issue a "redline". The UK is asking for concessions that the EU feels have already been agreed upon. The tensions have laid bare the difficulty in dealing with the Northern Ireland customs check and the impact on the UK economy given the uncertainty. High inflation, increasing interest rates and continued Brexit threats will be some of the headwinds facing Britain in the year ahead.

## FAR EAST & EMERGING MARKETS

***Contributed by Carel la Cock***

- The IHS Markit Asia Sector Purchasing Manager's Index for September showed that growth was achieved in eight of the eighteen sectors tracked by the survey, which was an improvement from the month before, but still below the breadth of growth achieved in April. Technology equipment was the top performing sector followed closely by Machinery & Equipment while Banks, Healthcare Services, Insurance and Pharmaceuticals & Biotechnology also saw improvements. Consumer Services registered its first expansion in activity since May. In contrast Automobiles & Auto Parts had its worst decline in output since May 2020, but encouragingly new orders fell at a slower pace than output and employment levels improved markedly, giving hope of a recovery in months ahead. The IHS Markit ASEAN Manufacturing PMI for September showed that manufacturing across the region stabilised with a neutral reading of 50, recovering from 44.5 posted in August. Both output and new orders stabilised across the region and three of the seven constituent countries recorded expansions in the month. Singapore (+9.1) saw the strongest improvement followed closely by Indonesia, while the Philippines was the only other country to improve modestly. Thailand and Malaysia reported deteriorating manufacturing conditions underpinned by weak demand. Vietnam recorded its fourth consecutive monthly decline, impacted by the current wave in covid-19 infections. The reading of 40.2 was unchanged from the month before and stuck at record lows. Lewis Cooper, economist at IHS Markit warned "Inflationary pressures add to downside risks, with the latest data highlighting the steepest increase in cost burdens for nearly eight years. COVID-19 restrictions and rising cases in parts of the region continue to adversely impact goods producers, and until this subsides, it's unlikely we will see a meaningful return to growth for the manufacturing sector."

## KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

| | | |
|---|---|---|
| JSE All Share | + 11.26 | 66101 |
| JSE Fini 15 | + 16.75 | 14079 |
| JSE Indi 25 | + 6.72 | 83131 |
| JSE Resi 20 | + 9.78 | 63203 |
| USD/ZAR | + 2.46 | 15.07 |
| EUR/ZAR | - 3.11 | 17.41 |
| GBR/ZAR | + 1.94 | 20.49 |
| S&P 500 | + 16.11 | 4361 |
| Nikkei | + 2.84 | 28223 |
| Hang Seng | - 7.95 | 25066 |
| Shanghai | + 2.34 | 3554 |
| FTSE 100 | + 10.62 | 7146 |
| Gold | - 7.43 | 1757 |
| Platinum | - 5.51 | 1013 |
| Brent oil | + 61.41 | 83.61 |

## BOTTOM LINE

*Contributed by Nick Downing*

- The JSE weakened during the third quarter (Q3) in line with global markets, which came under pressure from a resurgence of Covid infections, a gradual withdrawal of pandemic-era stimulus and a slowing in the pace of economic growth. The JSE All Share index lost 3.1% over the quarter, trimming its gain for the year-to-date (YTD) to 8.2%. Commodity shares were

**the biggest losers, due to a deluge of bad news from China's resource hungry economy.** The Resource 20 index, which tends to be more volatile at the best of times, fell 9.6% giving it a slim YTD return of just 0.9%. China's woes also affected the Industrial 25 index, which dropped 5.6% although maintained a YTD return of 5.2%. Index heavyweights Naspers and Prosus succumbed to China's regulatory crackdown on Tencent, e-commerce and gaming. For once, domestic shares outperformed, helped by attractive valuations and the rebound in domestic economic activity, which boosted financial shares. The Financial 15 index surged by 12.7%, lifting its YTD return to 21.3%. As global markets became more risk averse, the rand depreciated versus the US dollar in line with other emerging market currencies, by 5.5% in Q3 and 2.5% YTD to R/$15.07. The rand's weakening bias undermined bond returns. The All-Bond Total Return index only increased by 0.5% over the quarter, lifting the gain for the year to 5.5%. A stronger dollar impacted the dollar gold price, which fell 2.4% and by 8.5% YTD, settling at $1759 per ounce.

- **It is surprising that South Africa's financial markets were not weaker during the past quarter, considering the looting frenzy across KZN and Gauteng in the week 10-17th July.** The crisis prompted futurist and scenario planner Clem Sunter to increase the probability of his "Low Road" scenario, in which the country descends into anarchy, from 30% to 50%. Studies have shown that historically there is a very high chance of civil unrest within 14 months of a pandemic, especially in poorer countries with high unemployment. South Africa's unemployment rate surged to 34.4% in Q2, from 32.6% the previous quarter. The number of unemployed jumped by 584,000 to 7.8 million, employment fell by 54,000 to 14.9 million and the labour force increased by 530,000 to 22.8 million. The expanded definition of unemployment, including people who have stopped looking for work, increased from 43.2% to 44.4%. Youth unemployment, between ages 15-24 hit a record high 64.4%. Despite the disappointing employment data, total employee compensation was 2.8% higher in Q2 than two years earlier in Q2 2019, prior to the pandemic. This helps explain the resilience of the economy, which according to high frequency business survey data, appeared to rebound rapidly from July's chaos. After slumping to a contractionary sub-50 reading of 43.5 in July, the Absa manufacturing purchasing managers' index (PMI) rebounded in August to 57.9 indicating a healthy recovery path. The IHS Markit PMI, which measures economic health across the entire private sector, jumped from 46.1 to 49.9 confirming a return to economic stability.

- **Although July's events will inevitably affect Q3 GDP data, the economy outperformed expectations in Q2. GDP grew by a stronger than expected 1.2% quarter-on-quarter and 19.3% year-on-year, boosted by strong agricultural and export sectors, which grew output on the quarter by 6.2% and 4%, respectively.** However, the recovery was not broad based. Four sectors contracted over the quarter, including manufacturing, construction, the finance, real estate and business services sector, and government services. The construction sector is the furthest way from recovering its pre-pandemic level, at 20% below Q4 2019 output, while mining has already exceeded its pre-Covid peak, helped by the surge in global commodity prices. The trade, catering and accommodation sector remained weighed down by ongoing lockdown restrictions and social distancing, although the sector should start to recover swiftly under adjusted level 1 lockdown, in place since 1st October. International visitors will pick-up with the recent relaxation of travel bans. On 7th October the UK finally removed South Africa from its "red list", so that fully vaccinated travelers returning to the UK no longer have to spend 10 days in quarantine. Unfortunately, capital investment continued to lag, reflecting the depressed appetite for new investment which predated the pandemic. In the first half (H1) of the year, gross fixed capital formation was only 1,1% higher than the very depressed H1 2020 and July's unrest may have a lasting impact on investment confidence.

- The global commodity boom has bolstered the trade balance. In the year to the end of August, the trade surplus surged to R332 billion compared to R135 billion in the same period last year. The current account balance moved from a surplus of 4.3% of GDP in Q1 to 5.6% in Q2. Merchandise exports, which include agriculture, mining and manufacturing, increased to a new all-time high in Q2. The economic outlook was lifted further when Stats SA revised its GDP figures. Under the revisions, the economy was 11% larger in 2020 than previously estimated with GDP raised from R4.9 trillion to R5.5 trillion, GDP contracted in 2020 by 6.4% rather than 7.0%. The revised estimates make a sizeable contribution to improved economic and fiscal ratios.

- South African Reserve Bank (SARB) governor Lestja Kganyago said the large current account surplus, domestic fiscal consolidation and tame inflation rate are key factors which should help the economy and the rand weather the storm of rising US interest rates. The SARB highlighted that relative to the Fed taper tantrum of 2013, South Africa was now far better prepared for the removal of US quantitative easing and monetary policy normalisation. Despite the social unrest, the rand has remained remarkably stable. With so little expected in the way of good news, the currency tends to discount the worst-case scenario so that when events occur such as July's social unrest, a muted response can be expected. A stable rand, weak domestic demand conditions and benign consumer price inflation (CPI), which dropped from 5.2% year-on-year in May to 4.6% by July, should allow the SARB to lift its repo interest rate in gradual increments. The repo rate has remained at 3.5% for seven consecutive policy meetings since July 2020 after dropping a cumulative 275 basis points since the onset of the pandemic. A historically low interest rate offers a pillar of support for the economy.

- The SARB forecasts CPI will stay anchored at 4.2% in 2022 and 4.5% in 2023, and revised its GDP forecast upwards to 5.3% this year from a previous 4.2%, despite an expected quarter-on-quarter slowdown in Q3. However, growth forecasts in 2022 and 2023 are disappointing, at 1.7% and 1.8%, down from the previous forecasts of 2.3% and 2.4% and more akin to the slow growth that prevailed prior to the pandemic than a step change to a higher growth trajectory. A faster growth trajectory requires bolder and more urgent structural reform. Transnet announced that it is seeking private investment to expand its facilities in Durban and Coega, and Denel has announced it will sell assets and reduce its operating divisions by two-thirds, indicating a gradual but encouraging step towards restructuring and partial privatisation of state-owned enterprises.

- The current valuation of the JSE is extremely low. The price earnings ratio is 11.6x, not much higher than the low of 9.4x on 19th March 2020 and well below the 5-year average of 14.1x. The price-to-book ratio stands at 1.87, only slightly above the 25-year low of 1.70 plumbed in 1998 and well below the high of 3.07 reached in 2007. The dividend yield is also compelling at 4.05%, well above current money market rates. Admittedly, the market's low valuations are partly attributed to the recent derating in Naspers and Prosus, and mining shares, which together make up a sizeable portion of the JSE All Share index. Notwithstanding these effects, the market is undeniably cheap and appears to be discounting negligible potential for good news. The upcoming local government elections on 1st November will likely boost President Ramaphosa's authority within the ANC and galvinise his reformist drive. Similarly, July's civil unrest should act as a catalyst for change. The JSE is cheap, providing investors with a comfortable margin of safety against systemic risk events and at the same time significant upside potential if, as expected, the pace of structural reforms begins to pick up.

## Disclaimer