OVERBERG MARKET REPORT

Tuesday 19th October 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Werner Erasmus

- Any investor following the markets, reading the business section of their favorite newspaper, or receiving a weekly newsletter from their respective investment company would have noticed an increased mention of *bond yields* and/or the *yield curve* over the past few months.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Manufacturing production came in better than expected in August as businesses moved on from the violence and looting that disrupted activity and supply chains. Manufacturing production increased by 1.8% year-on-year. The largest positive contributions were made by food and beverages (up 9.7%); motor vehicles, parts and accessories, and other transport equipment (up 17.7%) points); basic iron and steel, non-ferrous metal products, metal products and machinery (up 7.6%); wood and wood products, paper, publishing and printing (12.5%); and furniture and 'other' manufacturing (up 19.8%). The largest negative contribution was from the petroleum, chemical products, rubber and plastic products division (down 21.8%). On a month-on-month basis, manufacturing production increased by a solid 7.6%, although the gain was amplified by July's low base. While the August manufacturing numbers were encouraging, the sector is still confronted with low levels of investment and continued job shedding. Rotational loadshedding is also putting pressure on manufacturing activity.

- Growth in mining production slowed, rising by 2.0% year-on-year in August, following an upwardly revised 12.3% increase in July. The increase was mainly driven by gold, which climbed 17.0% year-on-year, followed by iron ore output (up 22.9%). These notable increases were counteracted by sharp output declines in a range of metals, including nickel, copper and coal. On a monthly, seasonally adjusted basis, total production was down by 2.4% in August, after rebounding by 4.1% in July. Mining production levels seem to have normalised as most of the base effects from the 2020 lockdown-induced disruptions have dissipated. Encouragingly, mineral sales rose 35.1% on the year, little changed from 35% in July. This was supported by the global economic recovery and resulting increased global demand for commodities leading to much higher commodity prices. However, global economic growth conditions have started to ease. Looking ahead, further waves of Covid infections and lockdowns remain a downside risk to the global growth outcome and accordingly South Africa's growth trajectory, which is significantly influenced by the export of commodities.

- South Africa's retail trade declined in August by 1.3 % year-on-year, following a 1.2% fall in July and defying market forecasts of a 2.6 % increase. It was the second straight decrease in retail activity since March, partly due to the lingering effects of recent violent events across the country. According to Stats SA, the categories that were the largest contributors to the contraction were general dealers; retailers in hardware, paint and glass; "other" retailers which includes online retailers; and retailers of household furniture, appliances and equipment. August retail sales volumes show that the consequences of July's events will linger until businesses are restored to full capacity. Going forward, however, lower levels of Covid-19 lockdown, improved roll-out of income support grants and low interest rates combined with some improvement in consumption credit uptake, should be supportive of retail sales volumes. Furthermore, recent growth in non-labour income, such as dividend income, should provide additional support. Nonetheless, these must be weighed against still depressed consumer sentiment, slow readjustments in the labour market and potential future waves of Covid-19 infections.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Werner Erasmus

- Consumer Price Inflation, due Wednesday 20 October. Consumer Price Inflation (CPI) is expected to have increased in September towards the upper end of the 3%-6% target band set by the South African Reserve Bank (SARB). The consensus forecast is that inflation increased to 5% year-on-year from 4.9% in August. The main drivers are expected to be the weighty rental category, high fuel costs and rising food prices. Core inflation, which excludes food and fuel, is expected to have remained stable at 3.1% year-on-year.

GLOBAL

Contributed by Nick Downing

- In its bi-annual World Economic Outlook report, the IMF cautioned that the global economic recovery was losing momentum and at the same time inflationary risk was rising. In its forecast, the IMF expects global GDP to increase by 5.9% this year, dropping to 4.9% in 2022. Its forecasts for average inflation across developed economies were lifted from 1.6% to 2.8% in 2021 and from 1.7% to 2.3% in 2022. According to the IMF report, the supply-demand mismatch across the world economy was persisting for longer than expected and ran the danger of embedding itself into increased inflationary expectations and a spiral of wage and price increases. The IMF warned central banks to be "very, very vigilant", to watch out for second-round effects feeding into wages and core prices. and take early action in tightening monetary policy if necessary. In the past week, at a meeting of central bankers from the G20 leading economies, delegates shared the concern over embedded inflationary expectations but stated that the balance between supply and demand is likely to be restored over coming months.

NORTH AMERICA

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- Inflation data was stronger than expected in September. Consumer price inflation (CPI) gained by 0.4% month-on-month, up from 0.3% in August, while after a slight dip in August the year-on-year rate returned to 5.4%, the same figure recorded in June and July. Core CPI, which excludes food and energy prices due to their volatility, remained unchanged at 4% but the monthly rate picked up from 0.1% to 0.2%. There was a broadening in inflationary pressures away from the earlier inflationary culprits. Prices of used cars and trucks, and airlines fell by 0.7% and 6.4% on the month. However, rents which comprise 30% of the CPI basket, increased by 0.5% on the month, the biggest increase since 2001. Food and energy prices climbed sharply, by 0.9% and 1.3% on the month. The Wall Street Journal economists' survey, conducted from 8-12th October, confirms a sharp increase in inflation forecasts. The average forecast predicts a CPI rate of 5.25% in December which would suggest the longest stretch of plus-5% inflation since 1991. The survey predicts that on average inflation will then subside to 3.4% by the end of the second quarter next year and 2.6% by end 2022 although the supply chain bottlenecks blamed for current pricing pressures are expected to persist for another 8 months. There are indications that inflationary expectations are gradually becoming embedded at business level. According to the National Federation of Independent Business, 46% of small businesses planned to pass on higher material and labour costs to consumers by increasing prices. This marks the highest percentage since 1986. Meanwhile, the Social Security Administration announced that the raise in social security benefits, which is tied to inflation, will be 5.9% this year, the highest increase since the early 1980s. The signs of growing inflation risk are clearly visible.

- Minutes from the Federal Reserve's policy meeting on 21-22nd September reveal a growing concern that earlier inflationary pressures tied to the reopening of economies may not be as "transitory" as first expected. According to the minutes, "The staff interpreted recent inflation data as indicating that supply constraints were putting a larger amount of upward pressure on prices than previously anticipated." A much weaker than expected September nonfarm payroll figure, which showed 164,000 new jobs created compared with a consensus forecast 500,000, is unlikely to deter the Fed from tapering its asset purchase programme. A formal taper announcement is expected at the next policy meeting on 2-3rd November. The minutes reveal that the $120 billion per month programme will be tapered by $15 billion per month, so that it expires by June next year. Of the 18 members of the Federal Open Market Committee, half now expect the first interest rate hike to occur in 2022 and the majority expect three rate hikes by end 2023. There is concern at the Fed that the risk of household and business inflation expectations could move "appreciably higher", which appears to be lending a greater sense of urgency to its path towards policy normalisation.

- Retail sales increased in September by a stronger than expected 0.7% month-on-month. Consumers remain resilient but the data is not adjusted for inflation and so also reflects the impact of rising prices. The University of Michigan US consumer confidence index dipped in October from 72.8 to 71.4, with consumers expressing increased concern over rising prices, shortages and falling confidence in government policy. The decline in Covid cases is being replaced by surging energy prices and inflation as the key concerns for consumers. Consumers' expected inflation one year ahead moved higher from 4.6% to 4.8%. However, there was a decline in longer-dated inflation expectations, with the rate for 5-10 years out falling from 3% to 2.8%, suggesting that consumers are buying into the "transitory" message broadcast by the Federal Reserve. The current conditions measure of consumer confidence fell by a greater magnitude, from 80.1 to 77.9, than the forward expectations measure, which fell from 68.1 to 67.2.

CHINA

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- China's GDP growth slowed in the third quarter (Q3) by more than expected. Beset by regulatory crackdowns, the Evergrande group's financial distress, and an energy crisis, the economy grew in Q3 by just 4.9% year-on-year down sharply from 7.9% in Q2. New construction, by area, fell in the year to end September by 4.5% year-on-year compared with a 3.2% equivalent decline the previous month. Other sectors of the economy managed to grow but a slowdown was nonetheless apparent. Growth in fixed asset investment slowed to 7.3% in the year to end September from an equivalent 8.9% the previous month. Industrial output growth slowed from 5.3% year-on-year in August to 3.1% in September, affected by surging energy costs and power shortages. Consumer spending provided a bright spot, with retail sales up in September by 4.4% on the year compared with 2.5% in August, benefitting from a relaxation in Covid prevention measures. The urban unemployment also reduced, to 4.9% from 5.1% in August. The National Bureau of Statistics provided some comfort on the two most troubling economic risks, predicting that the energy crisis would be temporary and that the real estate market had generally stabilised. Despite considerable economic headwinds, GDP still managed to eke out positive quarter-on-quarter growth of 0.2%. The government and People's Bank of China (PBOC) are likely to increase the pace of policy stimulus over coming months to shore up economic growth. While the year-on-year pace of producer price inflation accelerated in September from 9.5% to 10.7%, its highest since 1996, consumer price inflation anchored at 0.7%, giving the central bank ample room to boost monetary stimulus. The government will provide fiscal stimulus, to assist the rocky property market and to boost infrastructure spending.

JAPAN

Contributed by Carel la Cock

- Japan's new prime minister, Fumio Kishida, will pivot the country away from neoliberalism, the political approach which has underscored his predecessors' policies for more than a decade. In an interview with the Financial Times, Mr Kishida criticized the government for its failure to bring prosperity to large parts of the population and to create a "virtuous cycle". Despite the success of Abenomics in growing the economy, increasing corporate earnings and leading to the stock market more than doubling, Mr Kishida feels that it only benefited "certain segments" of the population. He wants to focus on narrowing the gap between the rich and poor and by doing so creating the virtuous cycle that will fuel consumption. He pledged tax-incentives for companies to raise wages and to increase pay for nurses and care workers. He also wants Japan to become a self-sufficient economy in terms of "technologies that are critical to complete global supply chains so we can achieve indispensability". Another area of reform is to lessen the burden of corporate governance, another pillar of Abenomics, for small and mid-cap firms. Mr Kishida will be contesting the upcoming general election with an approval rating of 50%, lower than his predecessors going into office, although it is widely expected that his LDP party will win the elections at the end of the month.

EUROPE

Contributed by Carel la Cock

- House prices in the euro area increased by 6.8% in the second quarter of the year compared to the same quarter in 2020. It marked the steepest rise in house prices since the last quarter of 2006 and the eve of the global financial crisis. Quarter on quarter, prices rose 2.6% accelerating from 1.3% in the first quarter. More than ten member states, for which data are available, had annual growth of more than 10% in the second quarter. Estonia (+16.1%), Denmark (+15.6%) and Czechia (+14.5%) recorded the highest growth. Latvia (+6.7%), Slovenia (+4.5%) and Austria (+4.2%) saw the steepest rise since last quarter while all countries reported quarterly price increases. Economists are concerned about the threat to financial stability that a housing bubble poses. Historic low interest rates and accumulated savings during the pandemic have been key drivers in the surge of house prices, making them unaffordable for millions of potential buyers. A report from the Organisation for Economic Co-operation and Development (OECD) earlier this year showed how the nominal house prices index (+220) has outstripped the weekly earnings index (+180) and consumer price index (+157) since the turn of the millennium. Although house price inflation is not included in headline inflation figures, economists are concerned about the social consequences of surging house prices in urban areas and major cities. Supply chain disruptions and material shortages have exacerbated the supply of new homes while demand has remained buoyant. Commercial landlords, enticed by high returns have crowded out residential buyers causing protests in Spain and leading to a successful referendum in Germany as Berliners seek to expropriate 240,000 properties from corporate landlords for fair compensation. Although the referendum is not legally binding, it has highlighted the growing frustration with unaffordable house prices and rising rents. Christine Lagarde, president of The European Central Bank (ECB), said in July she does not believe there is a risk of a housing bubble forming, but given high household debt and rising interest rates on the horizon, an overheating property market could spell danger for financial institutions.

UNITED KINGDOM

Contributed by Carel la Cock

- Rishi Sunak, chancellor of the exchequer, will deliver his Budget speech later this month and it is expected that his government will tighten fiscal policy after significant spending during the pandemic. Mr Sunak will have his work cut out as rising energy prices and a deteriorating medium-term outlook pose significant threats to the recovery from the pandemic. The Institute for Fiscal Studies together with Citi Group, estimate that the pandemic has left a long-lasting scarring on the economy and that output will be 2 to 3% lower than pre-pandemic levels. Earlier in the year, Mr Sunak raised tax income by hiking corporation tax, income tax and national insurance, but is now considering cutting the 5% VAT on energy prices to soften the blow of surging energy bills on households. The 5% tax on energy bills stems from European regulations and cutting it was one of the campaigning slogans for Brexit advocates. However, critics say that it would be a disproportionate tax relief, benefitting the higher-income cohort more. It would also mean that Britain is effectively subsidising the burning of gas which will be problematic ahead of the UN COP26 climate summit in Glasgow. There are also calls for the closing of a contentions pension tax loop. Rules implemented in 2015 allow wealthy pension investors to bestow unused retirement funds to heirs, untaxed, when they die before the age of 75. The Institute for Fiscal Studies has called for the rules to be reviewed calling it “very, very generous”. While none of the proposed tax increases have been confirmed, Mr Sunak believes that with interest rates like to rise, it is important to keep public spending down and his next budget will likely be one of austerity.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 12.43	66792
JSE Fini 15	+ 16.69	14072

JSE Indi 25	+ 8.47	84496
JSE Resi 20	+ 10.51	63625
USD/ZAR	- 0.43	14.63
EUR/ZAR	- 5.29	17.05
GBR/ZAR	+ 0.29	20.15
S&P 500	+ 19.45	4486
Nikkei	+ 6.62	29261
Hang Seng	- 5.59	25708
Shanghai	+ 3.46	3593
FTSE 100	+ 11.51	7203
Gold	- 6.47	1775
Platinum	- 1.80	1052
Brent oil	+ 62.72	84.29

BOTTOM LINE

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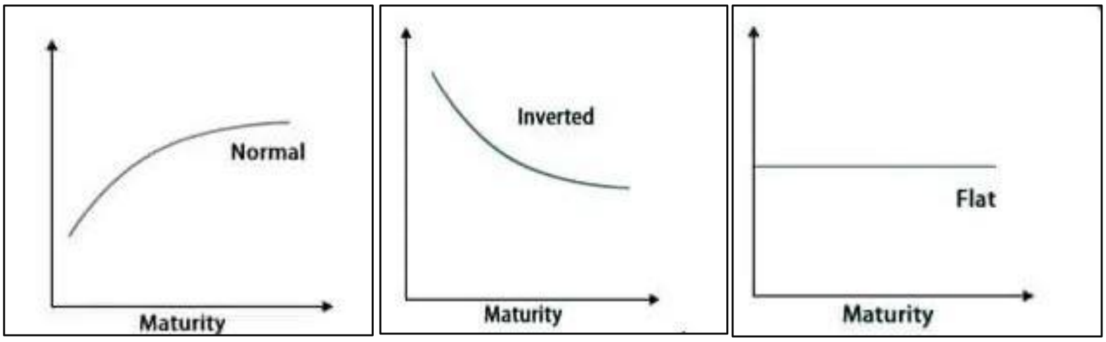
- Introduction: Any investor following the markets, reading the business section of their favorite newspaper, or receiving a weekly newsletter from their respective investment company would have noticed an increased mention of *bond yields* and/or the *yield curve* over the past few months. Unless you are a professional investor, most individuals would have asked themselves what on earth is that? Are these factors that important and how are these factors linked to vital economic and market factors such as economic growth, inflation, interest rates, and earnings growth? The short answer is yes, bond yields and the resulting yield curve are very important investment topics that tend to have a big effect on the market. I will attempt to put bond yields and the yield curve in perspective and explain their relative importance by answering some of the more generally asked questions about these topics.

- What is a bond yield? In short, a bond yield refers to the return on a bond when held until maturity. Similarly, when one talks about the yield on cash, you refer indirectly to the return on cash. Just like cash, bonds give an investor income in the form of a coupon (like interest). These coupons are fixed and usually paid twice a year. The yield on your bond is the coupon divided by the price you paid for the bond. For example, if you pay R1000 for a bond that pays you an annual coupon of R100 the yield on the bond will be 10% (R100/R1000). Bonds trade in the open market which means the price of a bond can fluctuate resulting in the bond yield increasing or decreasing.

- What is a bond price? The confusing part comes in when investment professionals and commentators talk about rising/declining bond yields and declining/increasing bond prices without distinction. That is because they are referring to the same thing. When bond yields go up it means that the price of the bond has decreased and vice versa. Bond prices fluctuate with changing market sentiment and the economic environment. The greatest influence on bond prices are interest rates, which normally tend to change when inflation changes. Bond prices have an inverse relationship with interest rates. In other words, when interest rates go up the value of bonds (In the secondary market) go down and vice versa.

- What is the yield curve? The yield curve is created from various data points. The yield curve is the line that forms when plotting the yields of similar-quality bonds with different maturities, from the shortest to the longest maturity. This line can either be flat, slope upwards or downwards as per the examples below.



- If short-term bond yields are lower than long-term bond yields the yield curve is upward sloping and called a positive or normal yield curve. If short-term bond yields are higher than long-term yields the line is downward sloping and called negative or inverted. If there is little difference between yields the resulting yield curve is called flat. In a recession, the yield required from long-maturity bonds tends to be low (bond prices are high) since investors expect interest rates to decline from prevailing levels, while yields on short-term maturity bonds are comparatively high as the interest rate cutting cycle takes time to implement. This results in an inverted yield curve. The converse situation occurs in expansions, with longer-dated bonds reflecting higher yields due to an anticipation of rising inflation and higher interest rates in the years ahead. A flat curve indicates that there are no strong views on either growth or inflation. In summary, the slope of the yield curve gives an idea of future interest rate changes and economic activity.

- Why is this important? In South Africa, the slope of the yield curve has historically anticipated changes in the economic cycle (by between three and eight months). Earnings growth for companies, and hence the overall market, move in tandem with the economic cycle and you would therefore expect the yield curve to anticipate the earnings growth of the market.

- How is it relevant to my portfolio? Over the longer term, the most important driver of share prices and hence returns is earnings growth. Where earnings go prices will eventually follow. The slope of the yields curve provides a good indication of economic turning points, the economic cycle and earnings growth.

- Conclusion: Rising bond yields typically signal investors are hopeful for more economic growth in the future but they can also indicate that a potential spike in inflation is just around the corner. Often investors worry that an increase in bond yields and longer-term interest rates will have a negative effect on market returns. However, if rates are rising because the economic growth outlook is picking up, higher interest rates should not deflect the stock market. Unless there is a sustained inflation surge, rising bond yields may only have a minor impact on stocks.

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