OVERBERG MARKET REPORT

Tuesday 5th October 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- The surge in equity markets paused for breath in the third quarter (Q3) as the Covid Delta variant delayed the full reopening of economies, especially in the Far East where supply chains continued to be disrupted. The world economy is past its point of peak growth, prompting investors to readjust their outlook.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- Private Sector Credit Extension (PSCE) growth continued to improve, accelerating to a six-month high, reflecting firmer economic activity, as trading conditions normalised following the violent protest and riots in KwaZulu Natal and parts of Gauteng in July. Private sector credit extension (PSCE) grew 1.1% year-on-year in August, following a 0.7% year-on-year expansion in July. Household credit grew by 5.7% in August, the strongest since March 2020. The biggest driver of household credit was the subcategory of asset-backed credit (7% growth), which outpaced the unsecured credit subcategory (1.4% growth). Asset-backed credit was mainly supported by low interest rates and a modest improvement in household income. Corporate loans and advances were essentially steady in August, following a moderate increase in July that lifted it from the March-June 2021 weakness. Corporate loans and advances contracted 1.1%, which is (bar July) the shallowest contraction since March 2021. Corporate credit will likely take time to sustainably gain momentum. Looking ahead: household credit growth is expected to steadily improve off last year's low base, buoyed by household demand, with continued support from modest growth in disposable income and low interest rates. However, the unfavourable jobs market will partly limit the upside, which is weighing on consumer confidence and credit demand. Corporate loans will also pick up as some companies affected by the riots in July start to rebuild.

- Annual producer price inflation (PPI), as measured by the producer price index, was 7.2% year-on-year in August, up from 7.1% in July. The upward pressure continued to come from coke, petroleum, chemical, rubber and plastic products; food products, beverages and tobacco products; and metals, machinery, equipment and computing equipment. Petrol and diesel inflation remained elevated at 23.8% and 16.6%, respectively. Year-to-date (January to August) producer inflation has averaged 6.1%, higher than the 2.4% and 5.4% averages for the corresponding periods in 2020 and 2019, respectively. This year's higher producer inflation reflects last year's pandemic-induced low base and elevated input prices from raw material shortages. Overall, producer inflation appears to be levelling off, but upside risks remain. Tight oil supplies and the resulting increase in oil prices, persistent disruptions to global supply chains and higher shipping and container tariffs will probably keep global producer inflation elevated for some time. Another threat comes from stubbornly high global food prices.

- The trade surplus for August increased to R42.4 billion, up 6.1 % month-on month from R39.96 billion recorded in July. Exports increased by 9.7% month-on-month while imports rose by 8.0%. The export rise was driven by base metals, the value of which rose by 23% on the month. Among imports, purchases of chemical products rose the most in August, by 16%. Meanwhile, imports of vegetable products decreased by 31%. Year-to-date South Africa's accumulated trade surplus stands at R332.13 billion, a significant improvement from the R134.95 billion surplus for the comparable period in 2020. Exports increased by 21.1% year-on-year whilst imports increased by 27.9% over the same period. Looking ahead: the elevated terms of trade are generally expected to unwind as import volumes start to recover and eventually outpace exports. Fundamentally, the persistent trade surplus should support the rand from an external funding perspective. However, the rand faces several risk factors, including the potential rise in US interest rates during 2022-23, the uncertain path of the Covid 19 pandemic and resulting lockdowns, and the lack of accelerated growth-enhancing reforms.

- The ABSA purchasing managers index (PMI) declined in September to 56.8, down marginally from the 57.9 points recorded in August. The ABSA PMI is a monthly gauge of manufacturing activity and an early indicator of underlying economic activity. The August reading, although down from the month before, was still well above the 50-point which separates expansion from contraction. The recent riots and unrest in July resulted in unusual fluctuations in the two preceding months. The business activity subindex, which is comparable to manufacturing production, dropped five points to 53.8. On a quarterly average basis, the business activity index measured 46.3 points during the third quarter, "down notably" from just above 55 in quarter two. "The weaker activity levels in the third quarter are in line with the trend in the Absa quarterly manufacturing survey and suggest that the manufacturing sector is likely to be a drag on the quarterly GDP momentum in the third quarter," Absa said. On the jobs front, the employment subindex remained in negative territory, despite a small uptick to 48.6 points which continues to suggest a lacklustre factory sector job market. Looking ahead, notwithstanding the various constraints such as supply chain bottlenecks, rising oil prices and a weaker rand, respondents to the PMI survey said they continued to expect an improvement in overall business conditions over the next six months.

- Although still dampened by a decline in export sales, which resulted from the knock-on effect of the July looting disruptions and the cyberattack on Transnet operations, new vehicle sales continued to recover in September. New vehicle sales increased to 43 130 in September, up 4% month-on-month from 41 425 vehicles sold in August. The latest increase has been supported by improved business and consumer confidence. The local recovery was driven by an increase in passenger car sales, which were up 30.5% year-on-year. Light commercial vehicles dropped 10.9% to 10,943 units, largely due to supply constraints on the Ford Ranger after the factory was closed for refurbishments in August. Sales of medium and heavy trucks increased 11.6% and 15.8%, respectively. Despite the overall recovery in September, new vehicle sales remain well below pre-pandemic levels. Looking ahead: improved business and consumer confidence, looser lockdown restrictions, better job prospects, and vaccine uptake will continue to support the industry while semi-conductor supply shortages and high logistics costs pose downside risk.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- IHS Markit Purchasing Managers' Index, due Tuesday 5 October. According to consensus forecast, the IHS Markit Purchasing Managers' Index (PMI) is expected to have increased to 50.1 in September from 49.9 in August, above the key 50-level indicating expansion. The slight uptick is expected as operating conditions continue to stabilise in the private sector economy as lockdown restrictions ease and confidence strengthens.

GLOBAL

Contributed by Nick Downing

- In April 2020, oil prices plummeted into negative territory amid a sudden stop in global demand. Prices have performed a 180 degree turn. Demand has surged with the reopening of economic activity, but supply growth has slowed sharply due to the transition to clean energy. Surging oil prices are an unintended consequence of decarbonisation. Investors, banks and regulators have cut back on new investment in fossil fuels. New drilling by US shale producers has dropped to a trickle. The International Energy Agency said investment in new fossil fuel projects must stop with immediate effect if the world is serious about meeting its net zero carbon emissions by 2050. OPEC has warned that despite the energy transition, global demand for oil will continue to rise until 2035 before levelling off and that to avoid future oil price shocks, the world needs to continue investing in new oil projects, to the tune of $11.8 trillion over the next 25 years. Natural gas prices have surged by 200% over the past year, as consumers move away from coal. The global surge in natural gas prices has been exacerbated by China's ambitious zero emission targets, prompting a faster than expected switch from coal fired energy. Rising energy costs are affecting inflation readings, which are rising while economic growth momentum is ebbing, fuelling concerns over stagflation. Stagflation, which describes simultaneous recession and inflation, is the worst-case scenario for investors.

However, some economists expect energy prices to correct sharply just as the rallied sharply in April 2020 after briefly hitting negative levels. Many of the energy supply constraints are short-term and prices are already discounting a cold winter, which might not materialise.

NORTH AMERICA

Contributed by Nick Downing

- Treasury Secretary Janet Yellen warned Congress that the Treasury would be unable to pay accounts unless the debt ceiling is either suspended or raised by 18th October, less than two weeks away. Government has shut down four times in the past, with the longest period of 35 days recorded in 2018-19. A more damaging consequence would be a technical default on the Treasury's debt obligations. The Washington based Bipartisan Policy Centre estimates the US government could default as soon as October unless the debt ceiling impasse is resolved. So far, Republicans are refusing to endorse raising the ceiling from its current level of $28.4 trillion. Yellen warned that in the event of a default, the US would "likely face a financial crisis and economic recession." Financial markets are starting to price-in a potential default, with Treasury bills maturing in October and November offering higher yields than longer dated bills. Meanwhile, the 10-year Treasury bond yield has risen sharply over the past two weeks from 1.32% to 1.50%. The US is one of the few nations that has a debt ceiling, and with past government shutdowns and today's rising threat of a debt default, some wonder if the risks of the debt ceiling don't outweigh its primary benefit, of limiting spending extravagance. Yellen said she would support eliminating the debt ceiling altogether.

- During Federal Reserve Chairman Jay Powell's testimony to the House Financial Services Committee, he admitted that the effect on inflation of supply side constraints were stronger and more persistent than originally anticipated. However, he stuck to his belief that the current inflationary spike would be temporary. He said, "We have an expectation that high inflation will abate, because we think the factors that are causing it are temporary and tied to the pandemic and the reopening of the economy." Nonetheless, he said that despite inflation being above the Fed's target, the economy is still far from achieving full employment, which is causing a policy conundrum. The Fed's view is that inflation will only start fading in 2022 rather than this year, as had previously been projected. In his testimony, However, Powell offered reassurance in his testimony that there was no sign yet of higher inflation becoming entrenched.

- Personal consumption expenditure, which accounts for over two-thirds of US GDP, bounced back in August, rising by a stronger than expected 0.8% month-on-month, following the 0.1% decline in July. The data signals that consumer spending, the main driver of economic growth, is recovering as the Delta variant recedes. Personal income increased by a healthy 0.2% on the month. The withdrawal of pandemic relief programmes is being outweighed by the accumulated hoard of household savings, estimated at around $2 trillion, combined with a surge in job openings and firm wage growth. Rising equity and residential property markets are also benefitting household balance sheets. The S&P 500 index has gained by 86% since its low point on 20th March 2020. The S&P Core Logic Shiller National Home Price index, measuring average home prices across US metropolitan areas, increased in July by 19.7% year-on-year, accelerating from June's 18.7% increase and capping the fourth straight monthly record gain. The University of Michigan US consumer confidence index recovered some of July's lost ground in August, rising from 70.3 to 72.8, although some survey respondents cited rising inflation as a reason to delay some purchases.

CHINA

Contributed by Nick Downing

- The private sector regulatory crackdown, followed by financial distress at Evergrande, the country's largest property developer, has now been trumped by another threat to China's economy, an energy crisis. Around 70% of the country's electricity production comes from coal fired power stations, which have struggled with coal shortages and surging coal prices as the country transitions to clean energy. President Xi Jinping set a target in September 2020 for China to reach peak carbon emissions by 2030, which has resulted in a rapid slowdown in new coal mining. As a result, coal production has failed to keep up with energy demand. Thermal coal prices have gained by over 140% since the start of the year. Two thirds of China's provinces have experienced load shedding. Factories have been forced to drop production days due to energy rationing. These measures and widespread loadshedding will affect production as well as demand. In the past week, Goldman Sachs cut its forecast for GDP growth in 2021 from 8.2% to 7.8%, citing the impact of energy shortages. The impact will also be felt globally, through further supply chain disruptions and cost pressures, causing the global inflation spike to persist longer.

- The official National Bureau of Statistics (NBS) manufacturing purchasing managers' index (PMI) fell into sub-50 contractionary territory for the first time since February 2020. The PMI dropped in September from 50.1 to 49.6, with several key sub-indices also turning negative, including new orders, new export orders, hiring and production. The PMI decline is attributed primarily to energy rationing, which particularly impacted high-energy consuming industrial sectors. There was some good news. The Caixin manufacturing PMI, which had turned negative in August, rebounded in September from 49.2 to 50. The private sector Caixin survey measures smaller private sector companies, which tend to be less energy dependent. However, the Caixin PMI export order sub-index slipped deeper below the 50-mark, indicating a drop in overseas demand. Meanwhile, the NBS non-manufacturing PMI, measuring activity in the services and construction sectors, jumped higher as the Covid Delta variant receded. The PMI gained from 47.5 to 53.2, driven by services which increased from 45.2 to 52.4, outweighing construction's decline from 60.5 to 57.5. While services provided a bright spot, the overall tenor of the data is broadly negative and may prompt the announcement of fiscal and monetary easing measures to shore up economic activity. The People's Bank of China resisted the global push for extraordinary pandemic-era monetary easing and as a result still has significant stimulus capacity. Its benchmark interest rate has remained on hold since April 2020.

JAPAN

Contributed by Carel la Cock

- Japan's Consumer Confidence Index rose to 37.8 in September, up 1.1 points from August and reaching a zenith since the start of the pandemic. Consumer optimism picked up across all sentiment sectors - Overall Livelihood (+1.1), Income Growth (+0.5), Employment (+2.9) and Willingness to buy durable goods (+0.1). The percentage of respondents expecting prices to rise in the year ahead jumped by 4% points to 82.5% in June, while only 3.9% expect prices to go down, 1.1% points lower than in August. Last year Japanese households saved a generous 11.4% of disposable income and in the first three months of this year savings amounted to 8.7%. Private consumption accounts for over half of Japan's nominal GDP and there is hope that once lockdown measures are lifted and households can resume their normal spending habits, a consumer led recovery could see the economy rebound sharply towards the end of the year. New prime minister, Fumio Kishida, who pipped his close rival, Taro Kono, to the post, is not expected to veer significantly away from current stimulus programmes in place. It is widely held that he won the vote as leader of the ruling Liberal Democratic party with support from MPs wishing for policy continuation and consistency. While international investors favoured the more internationalist Mr Kono, domestic companies can now focus on business as usual knowing there will be no radical policy changes on the horizon.

EUROPE

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- Inflation in the eurozone marched ahead in September with flash estimates putting the yearly advance as high as 3.4%. The cost of energy has soared in September, up 17.4% from a year ago and gained some pace from the 15.4% recorded in August. It has been a large contributor to overall inflation, but excluding energy prices, inflation for September was more moderate at 1.9%. Amongst the larger European nations, Germany saw inflation spike to a 29-year high at 4.1% while Spain saw a 13-year high at 4.0%. Italy (3.0%), France (2.7%) and Portugal (1.3%) were less pronounced but still chalked up multi year highs. Eastern European countries reported alarming price surges with Estonia (+6.4%), Lithuania (+6.3%) and Slovakia (+5.1%) amongst the worst affected. Although the European Central Bank's latest prediction still expects inflation to ease from 2.2% this year to 1.7% in 2022, supply bottle necks are proving to be more persistent than previously thought and together with sharp rises in energy costs have driven prices higher across a multitude of sectors. In Germany workers are striking and demanding higher wages. Economists fear that widespread wage negotiations could lead to inflation spiralling out of control rather than being transitory as expected. The ECB will give an update on its emergency asset purchases in December and many analysts expect them to be phased out over a shorter period than indicated at the last policy meeting.

UNITED KINGDOM

Contributed by Carel la Cock

- The latest IHS Markit/CIPS UK Services PMI Business Activity reading at 55.4 points to another strong monthly recovery in the UK's private services sector. However, the headline figure belies the fact that supply constraints and staff shortages continued to detract from new orders growth and have driven costs and output prices higher. Confidence amongst clients has returned following the end of lockdown restrictions, but companies have found it hard to keep pace with the increased demand which has caused backlogs to extend for a seventh month running. Surging fuel and energy prices together with higher staff costs have been passed on to consumers, leading to output price inflation marking the fastest pace since records began 25 years ago. While business optimism remains at elevated levels, the September reading was softer than in August. Duncan Brock, Group Director at the Chartered Institute of Procurement & Supply warns: "As prices charged rose at their fastest rate since 1996, it seems the floodgates are open for higher inflation to wash through the UK economy and firms fear the growth this month may be eroded further by higher costs and shortages as we move towards the festive period."

FAR EAST & EMERGING MARKETS

Contributed by Carel la Cock

- India is the latest victim of a global energy crisis that has already engulfed Europe, Britain and China. The country is facing potential blackouts as coal stockpiles dwindle from 13 days of supply in August to just 4 days. Nearly two thirds of India's power generation is sourced from coal fired plants and most of that coal is imported, Indonesia being a major supplier. However, surging coal prices, up more than 300% since the first quarter, coupled with an inward focus from government promoting economic recovery by self-reliance, have discouraged power companies from stockpiling imported coal. Heavy rains and general inefficiencies at India's domestic coal mines have exacerbated the situation, rendering state-owned India Coal Ltd incapable of meeting critical demand. The focus will now turn to secure coal stocks from abroad and to increase production at local mines, however there is a real likelihood of rolling blackouts which will be detrimental to the country's post-pandemic economic recovery.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 7.95	64129
JSE Fini 15	+ 19.50	14411
JSE Indi 25	+ 4.53	81428
JSE Resi 20	+ 1.87	58651
USD/ZAR	+ 2.48	15.07
EUR/ZAR	- 2.74	17.47
GBR/ZAR	+ 1.90	20.48
S&P 500	+ 14.49	4300
Nikkei	+ 1.19	27771
Hang Seng	- 11.45	24112
Shanghai	+ 2.74	3568
FTSE 100	+ 8.52	7011
Gold	- 7.34	1758
Platinum	- 10.28	961
Brent oil	+ 57.18	81.42

BOTTOM LINE

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- The surge in equity markets paused for breath in the third quarter (Q3) as the Covid Delta variant delayed the full reopening of economies, especially in the Far East where supply chains continued to be disrupted. The world economy is past its point of peak growth, prompting investors to readjust their outlook. While growth slowed, inflation continued to accelerate, the classic stagflation combination. The world has begun removing stimulus. Central banks around the world, including the Federal Reserve have signalled a pullback in pandemic-era monetary stimulus. The same goes for fiscal stimulus. US Covid relief programmes expired in September and furlough schemes across Europe and the UK have ended. The S&P 500 index dropped 4.8% in September, its worst month since March 2020, compressing its Q3 return to just 0.23%. The index still gained by 14.68% year-to-date (YTD), making it the world's best performing major market. Purchasing managers' index (PMI) surveys have rolled over. In some regions, PMIs signal a contraction in activity, especially in the Far East due to slower vaccination programmes and strict "zero tolerance" lockdowns. In the US, the IHS Markit composite PMI, measuring activity across both manufacturing and service sectors, sank to its lowest since September 2020. The Delta variant was blamed and its effect on both demand and supply. In addition, government's $300 per month enhanced unemployment benefit programme came to an end in the first week of September.

- In its latest quarterly report, the OECD reduced its global growth forecast for 2021 from 5.8% to 5.7%. It's forecast for US growth dropped from 6.9% to 6.0%. The key message, however, is that the Delta variant is only expected to delay business and consumer expenditure, not cancel it out altogether. In fact, the OECD raised it 2022 growth forecasts, for the US from 3.6% to 3.9% and for world growth from 4.4% to 4.5%. The stagflation threat also appears to dissipate, with the average inflation rate among G20 countries dropping from a year-on-year rate of 4.5% in Q4 to 3.5% by the end of 2022. Similarly, US inflation is projected to ease from 3.6% to 2.9% between 2021 and 2022. If anything, the growth projections are perhaps too conservative. There are several reasons to expect growth to exceed the OECD's projections.

- Fiscal stimulus will be cut back but by no means disappear. China, Japan and Europe are expected to increase stimulus. In the US, President Biden's Infrastructure and Build Back Better bills are expected to be passed by Congress before year-end, although watered down versions. Moreover, the expired furlough schemes and fiscal relief measures will continue to be felt for months if not years to come, as a large part of those fiscal transfers were saved rather than spent. As well as the massive pool of excess savings, estimated at over $2 trillion in the US, households have healthy balance sheets, with ample capacity for credit growth. Despite the recent loss in growth momentum, companies are ebullient, heralding strong investment and employment growth. The global Manpower Employment Survey has surged to unprecedented heights, while capex spending intentions are at their highest since the early 1980s, indicating considerable optimism over future profit growth. The recovery in global corporate earnings has been tremendous: 12-month forward estimates increased in August for a 14^{th} straight month and are already 15% above immediate pre-pandemic levels. The pace will moderate in the coming year but stick to its upward trajectory, in the likely base case scenario that the world economy continues to grow amid strong consumer and business spending. High yielding corporate bonds trade at historically narrow spreads, confirming the positive corporate outlook.

- As always risks abound but the known ones are unlikely to lead to a systemic risk event. It is widely accepted that the China Evergrande Group will default on its $300 billion debt obligations, but the fallout will not come close to the collapse of Lehman Brothers, which sparked the 2008/09 Global Financial Crisis. Rating agency S&P Global believes authorities will seek an "orderly debt restructuring that maximises the value of its substantial assets." In some regions, local governments have already assumed control of Evergrande's sales revenue to protect homebuyers' interests and enable the continuation of construction projects. Beijing, which has the necessary resources, will seek to protect the tens of thousands of home buyers and the household investors in Evergrande's wealth management products. While the government is intent on gradually letting air out of the real estate bubble, it will be anxious to avoid systemic risk. A "controlled explosion" is the most likely scenario.

- Central bank policy is also a key risk. The Federal Reserve will begin to reduce its asset purchase programme at the next policy meeting on 2-3rd November, reducing bond purchases to zero by mid-2022 after which it will start to increase the benchmark fed funds rate from its zero bound in gradual 25 basis point increments. The most likely start date for rate hikes is 2023 and even then, monetary policy will remain extraordinarily accommodative. According to the Fed's "dot plot" of policy members" rate projections, the terminal fed funds rate settles at 1.8% in 2024. This is hardly restrictive. Given the Fed's 2% Flexible Average Inflation Target, it suggests a negative interest rate. Central banks around the world will remove their policy stimulus at a glacial pace. They are purposefully targeting higher inflation. With rising government indebtedness, they fear deflation rather than inflation as the biggest threat of all.

- Nonetheless, inflation is rattling some investors' nerves. Eurozone inflation increased in September to a 13-year high of 3.4%. US inflation peaked at 5.4% in June with its 3-month annualised rate accelerating to 9.7% but has slowed. In August, it measured 0.3% month-on-month, down from 0.5% in July and 0.9% in June. Core inflation, excluding food and energy prices, increased by just 0.1%. The earlier inflationary culprits appear to be retreating. The all-knowing bond market shares the Fed's view that the current inflation spike is transitory. The breakeven rate between conventional Treasury bonds and the Treasury's inflation protected securities (TIPS), which measures the market's expected average inflation rate over the bond maturity, is currently anchored at under 2.4% over 10 years.

- Fears of another 2013-style taper tantrum are misplaced. In 2013, the 10-year Treasury bond yield spiked higher by 100 basis points in just two months but a whole 12 months before actual asset purchase reductions began. Some argue that the 2021 tantrum has already occurred, earlier this year from January to March when the 10-year yield jumped from 1.0% to 1.75%, also spanning two months and also around 12 months ahead of actual asset purchase reductions. Once the taper begins, financial markets will have already long discounted the event.

- Much is written about excessive stock market valuations. They are expensive. However, over-pricing is concentrated in a few sectors, in particular technology and especially in US markets. The US price-earnings multiple and price to book ratio are close to year 2000 levels. However, other markets offer value, where the same ratios are either around their long-term average, for instance Europe, or far cheaper than the average, for instance China and Japan and emerging markets. Japan's equity market is at its cheapest level versus the US since 1971. Moreover, the global market is getting steadily cheaper. Estimated forward earnings for global equities have risen faster than global share prices, which means the 12-month forward PE multiple has dropped from 20 to 18 since the end of last year.

- The overall tenor of the global economic expansion remains intact despite the recent slowdown. While past peak growth, global GDP is expected to rise over the foreseeable future at a faster pace than the decade following the Global Financial Crisis. Recent Delta-related lockdowns will delay rather than cancel the expected catch-up in household spending, inventory restocking and business investment spending. Equity markets will continue to make headway in an environment of above-trend GDP growth and rising corporate earnings, even in the over-valued US market, although some underperformance is expected compared with non-US markets.

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