overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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Global

Nick Downing

Europe exposure reduced

The world economy was enjoying unusually strong momentum before Russia invaded Ukraine. The factors supporting strong growth remain intact, notably strong household balance sheets, excess savings, a retreat of the Covid threat, a reopening of service sectors and supply chains, and depleted inventories which need to be replenished. Despite the solid economic backdrop, there are three “firsts”, which give pause to unbridled optimism. The yield difference between the 10-year US Treasury bond and the same maturity Treasury Inflation Protected Security (TIP), which measures the market’s expected annual inflation rate over the next 10 years, increased to 2.94% its highest level ever.

The Federal Reserve, undeterred by increased geopolitical risks, has guided that it will begin “quantitative tightening” (QT) in May. This is another first. In the past, in 2018, the Fed reduced the size of its balance sheet by allowing its bond holdings to “run off” upon maturity and not reinvesting the proceeds but it has never before actively sold its bond holdings onto the market. The QT programme will reduce the Fed’s balance sheet at an unprecedented pace, to the tune of $100 billion per month, a significant draining of liquidity from the financial system. The tide of global liquidity expansion which powered all financial markets higher in 2020 and 2021, has started to ebb. A higher oil price and stronger US dollar also dampens liquidity, but the effects of upcoming QT are an unknown quantity.

Third is Russia’s invasion of Ukraine, the first invasion and conflict of its magnitude since WW2. The longer the war continues, the more dangerous it will become. Putin, showing all the signs of irrational behaviour and who believes his life will be in danger of he loses power, is likely to escalate the crisis in the event of a stalemate either by expanding its boundaries or with the use of non-conventional weapons.

Despite positive underlying growth momentum, we are trimming equity exposure in our clients’ portfolios by 2-4%, depending on the risk profile. This is only a minor adjustment. Portfolios are already structured to withstand worst-case scenarios. This is achieved through effective diversification across asset classes, industrial sectors, geographical regions and currencies. We remain confident that global equity markets will end the year at higher levels but will use the cash proceeds to take advantage of expected volatility over coming months to re-enter the market.

We are trimming equity exposure by adjusting the regional tilt of portfolios away from Europe. Europe is most at risk due to its geographical proximity to Russia and Ukraine, its bank exposure to these economies and its dependence on Russian oil and gas. The likelihood of a sharp economic slowdown in the rest of the world is low but there is a distinct possibility of outright recession in Europe. Although European markets are cheap, especially versus the US, earnings are already being downgraded and so valuations may not be as cheap in 6- to 12-months’ time. The sale of European exposure coincided with a strong 2-week rally so that prices achieved were well above recent lows. Proceeds will be held in cash over the short-term.

LOCAL

Gielie Fourie

Small, Micro and Medium Enterprises in South Africa.

SMALL, MICRO and MEDIUM ENTERPRISESS (SMEs or SMMEs): The terms “SMEs” and “SMMEs” are used interchangeably in South Africa. According to the World Bank, SMEs play a major economic role, particularly in developing countries. South Africa is lagging. Why?

POLITICIANS, BUREAUCRATS AND REGULATIONS: Politicians and bureaucrats can make life extremely tough for SMEs. Ms. Stella Tembisa Ndabeni-Abrahams, Minister of Small Business Development and her department of bureaucrats are rule-based and rule-bound. The minister has a criminal record for a non-compliance offence. She told the public on 24 Jan 2022, “We have a responsibility to enforce regulatory compliance in the SME sector and close businesses that are trading illegally.” Jan de Villiers (DA MP) retorted: “The last thing SMEs need to hear is that the minister will be leading the witch-hunt against business owners who do not comply with government red tape.”

THE WORLD BANK’S OBSERVATIONS: The World Bank, on the other hand, sings the praises of the role of small business in terms of economic development and job creation: “SMEs play a major role in most economies, particularly in developing countries. SMEs account for the bulk of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90% of businesses and more than 50% of employment worldwide. Formal SMEs contribute up to 40% of national income (GDP) in emerging economies. These numbers are significantly higher when informal SMEs are included.”

THE ATTITUDES OF BIG CORPORATIONS AND GOVERNMENT: It is so much easier for a politician to deal with a large corporation than with a spaza shop. Deals with big business are often a lucrative option as well. They can finish their ‘public’ career and find a cushy politically connected job with one of the corporations that helped them regulate markets. It is good for big business, and it is good for politicians – it is a win-win relationship. It just is not good for the country or the unemployed. Politicians and bureaucrats know who is most likely to offer them a R3 million salary when they retire, and it isn’t the spaza in the township or the street vendor downtown. It is nothing more than a subtle form of corruption.

INFORMAL SMEs: Informal SMEs are unlicenced businesses, like many house/spaza shops. They are regarded as illegal traders. But they are often the only lifelines poor South Africans have for goods and services. So, a crackdown on illegal SMEs doesn’t just increase poverty for those who feel the wrath of bureaucracy, it also harms the customer base they serve. Often the people who fail to read the regulations are the very people who have the least education to begin with and are the most desperate to find a way to economically survive. These are people who have been failed by the current and previous governments their entire life. Instead of waging war on them, the minister would best serve the country by finding ways to help them survive, not close them down.

THE CONSEQUENCES OF OVER-REGULATION: Government will provide spaza shops with R7,000.00 repayable seed capital. Spazas need to be registered with the SA Revenue Service, the Unemployment Insurance Fund and the Companies and Intellectual Property Commission. The spaza shops must be owner-managed and must have a bank account. They must be willing to submit monthly management accounts for at least 12 months. Spazas must hold a permit to trade from the local municipality. It is critical for government to start eradicating irrelevant requirements to make it easier to register. Even those aware of the roadblocks to success set up by the state often have no choice but to operate informally and illegally, at least partially.

SUMMARY: The International Finance Corporation (a member of the World Bank Group) has urged the South African Government to try “reducing bureaucratic complexity and the costs involved with registration”. Government should be more business friendly. It should roll out red carpets for new businesses, not more red tape - government has more red tape than a red tape factory. Compliance has become such a big issue that it scares off many aspirant businesspeople. Callous bureaucrats have the power to cut off enterprising traders’ only source of income, holding back our vast economic potential. Who would dare to set up shop in such an unfriendly business environment?