overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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GLOBAL

Nick Downing

Market bottom is in sight.

Bear market rallies lend optimism on the slippery slope of hope. The rallies are amplified by low trade volumes. There has been a powerful rally in global equity markets over the past fortnight. The S&P 500 index has gained by 7%. The reasons given: Inflation has passed its peak, economic activity is holding up, China's lockdowns are over and the war in Europe does not seem to be escalating. It is common for bear markets to pause. No markets go in a straight line.

The million-dollar question: Have markets already hit the bottom? This depends on whether economies enter recession. Markets are still priced for earnings growth, albeit subdued. Whether we enter recession, in turn depends on inflation and central bank policy. If inflation comes down of its own accord due to slowing economic activity, central banks will be able to scale back interest rate expectations. Unfortunately, supply chain disruptions emanating from China and the war's impact on energy and food prices will keep inflation elevated regardless of economic activity levels.

There is already division among central bank policy makers. The hawks are determined to bring inflation back down to 2% target levels, regardless of what damage this wreaks on economic activity. The doves are keen to pause once benchmark rates approach the neutral level, which neither slows nor accelerates growth. In the US, this would mean pausing in September after the fed funds rate has been lifted by a further 100 basis points to 2%. The Fed estimates the neutral rate is around 2.75%. Some economists believe it is closer to 3.5%.

Central banks will be especially keen in this economic cycle to avoid recession. They will err on the dovish side, preferring to live, for a period at least, with elevated inflation rather than recession. After rescuing economies from the Covid pandemic, policy tools for combatting recession have been depleted, whereas measures available for combatting inflation are limitless. It is likely that central banks will claim victory if inflation drops from 8% to 5%. Some economists have suggested the Fed may even lift its Average Inflation Target from 2% to 3%. The world's major central banks would likely follow suit.

Inflation may remain undefeated, in the strict sense based on central bank targets. However, recessions are likely to be avoided and monetary policy will continue to remain accommodative. Therefore, global equity markets are likely much closer to the bottom than the top. We are probably more than two-thirds of the way through the bear market. It is time to prepare one's shopping list so that shares can be purchased without hesitation at lower levels.

How will we recognise the market bottom? Investors point to signs of capitulation such as heightened volatility readings or contrarian indicators like excessive investor pessimism. The catalyst for a market bottom will probably occur once central banks signal an end to monetary tightening. Developed Western economies are not at that point yet. The Fed still needs to hit full speed with its quantitative tightening policy, which will erase $100 billion per month from financial markets. Share prices and equity markets are likely to falter but at least the market bottom is in sight. It is unlikely that recessions will need to be priced in.

Equity market valuations are already becoming attractive again. The estimated forward price-earnings multiple of the MSCI All Country World Index has dropped to 15x from 18x at the end of last year and a peak of 20x in 2020. A cheaper entry level means that 10-year prospective returns are greatly improved, and long-term investment risks considerably diminished. Independent research firm, Capital Economics, projected on 31st May, that global equities would decline a further 3.7% by year-end, a modest decline compared to what we have endured so far, and set up for annualised returns of 10.8% in both 2023 and 2024.

LOCAL

Gielie Fourie

Infrastructure in South Africa.

INTRODUCTION: Infrastructure development is the construction of basic foundational services in order to stimulate economic growth and quality of life improvement. Most advanced economies have gone through periods of intensive infrastructure building. Infrastructure improves the efficiency and competitiveness of countries. It is an important job creator.

TRANSPORT INFRASTRUCTURE: Ironically, you need existing infrastructure to develop new infrastructure. To build infrastructure projects you need transport in its broadest sense, which includes roads, railways, running water supply and reliable electricity supply. You cannot start new projects without it. Unfortunately, South Africa's transport system is in such a bad state of repair that it is challenging and costly to build new infrastructure. "There can be no doubt that the transportation sector is the most critical sector of our economy", Robert Brady, a US politician, once remarked. Railways are by far the cheapest way to transport people and freight. In this report we focus on the decline of our railways and exciting plans for their revival.

RAILWAYS – A TRAIN WRECK: Unfortunately, Transnet is one of the most neglected government services. Our mines are the biggest clients of Transnet Freight. Transnet's annual report shows that mining's contribution to freight constitutes 50% of Transnet Freight's income. For the mines, Transnet is even more important than electricity. When Transnet's services fail to deliver it has *double* the financial impact of an electricity crisis. During a commodities boom, when mining exports rocket, SA cannot afford to have its rail industry misfiring. The cost to the economy is huge. Transnet's CEO, Portia Derby, (wife of Brian Molefe, previous Transnet CEO, and Saxonwold Shebeen regular) pointed out that stealing of overhead traction cables causes big disruptions. But these are external issues. Internal inefficiencies at Transnet are far worse.

RAILWAYS WHITE PAPER: A Rail Policy White Paper was approved by cabinet in March 2022, paving the way for further engagements with industry players. Government says it hopes to revive the country's rail sector through private partnerships, which will overhaul ownership and participation patterns. On Thursday last week, 2nd June, the minister responsible for Railways, Fikile Mbalula, and the minister of Public Enterprises, minister Pravin Gordhan, launched the new national rail policy in Johannesburg.

FIKILE MBALULA. Mbalula said in an address to dozens of transport business leaders and government officials, that the country's new rail policy will open up the industry to other players and examine structural reforms to bring about competitiveness. The policy document lists the challenges faced by rail over the years leading to its low market share of less than 20% for freight, and less than 10% for passengers. "The policy addresses passenger rail capacity challenges, where ‘concessioning’ is introduced on other lines other than those run by PRASA (Passenger Rail Agency of South Africa) - where private sector players can operate their services. The white paper presents a multi-decade plan of how the railway sector will evolve over time,” Mbalula said.

PRAVIN GORDHAN: Gordhan reiterated the need for the transformation of the sector, saying the high level of concentration in the economy in a few hands is a challenge. "We're going to require a lot of dialogue, a lot of exchange, maybe some arm wrestling as well, in order to come up with more creative ways in which there's a greater diversity of participation and effective operational roles for people who have traditionally been excluded from these areas of the economy itself," Gordhan said.

CONCLUSION: “We should not be waiting until trains derail, bridges collapse and people die to adequately fund our transportation infrastructure”, Elizabeth Esty, US politician. This is an exciting initiative. Unfortunately, Mbalula does not have a good “track” record. How can you share in infrastructure growth? You can either invest in builders of infrastructure projects, or in product suppliers. Examples are builders like Raubex and WBHO or suppliers like PPC, Italtile, Cashbuild or even Trellidor. Our clients own Raubex and Italtile. Contact one of our highly qualified consultants for a free consultation.