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WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

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Keeping at it at Jackson Hole

The annual Jackson Hole central bankers' symposium set the scene for more interest rate hikes. The severity of Fed chair Jay Powell's message took financial markets by surprise. His speech was unusually short, just 8 minutes but he stressed his point. He said the "overarching focus right now is to bring inflation back down to our 2% goal", that the Fed "will keep at it until we are confident the job is done." He cautioned that interest rate increases will "bring some pain to households and businesses" and a "sustained period of below-trend growth" but "these are the unfortunate costs of reducing inflation… a failure to restore price stability would mean far greater pain." In just 4 months the Fed has raised the fed funds rate from a target range of 0.25-0.50% to 2.25-2.50%. Earlier market expectations that the Fed would pivot to a looser monetary policy in the next few months were too optimistic. A further 75 basis point rate hike at the upcoming policy meeting on 20-21st September is now more likely. There is an urgency for the Fed to get back ahead of the curve. Powell warned that "The longer the current bout of high inflation continues, the greater the chance that expectations of higher inflation will become entrenched."

Warren Buffett famously said that "Interest rates are to asset values what gravity is to apples." The historic precedent is frightening. Let's see what happened to US equity markets in the 1970s, the last time there was an inflation problem. James Ferguson from MacroStrategy Partnership puts it succinctly. Equity earnings yields roughly track Treasury bond yields, which in turn track 10-year average CPI. If inflation rises bond yields and equity yields go up too. When the equity yield goes up, its inverse, the PE ratio, drops. He says: "The real equity earnings yield has historically always been positive (more than 10-year average inflation), such that in 1970, when CPI reached 6%, the equity earnings yield was pushed up to 7.2%. Likewise, in early 1975, CPI ascended to 11.3%, pushing the equity earnings yield up to 14% in June 1975: and again, when CPI rose above 13.5% in 1980, the equity earnings yield was forced up above 15%. The whole (equity) market average PE ratio at that time was a mere 6.5x." This compares with today's PE ratio of 19x.

How much do interest rates need to go up? Powell repeatedly used the phrase "Keep at it" in his speech, ominously similar to the title of past Fed chairman Paul Volker's memoire "Keeping at it", referring to his persistence in beating the inflation scourge of the 1970s. Under his watch, the fed funds rate hit a peak of 20% in June 1981. It all depends on inflation, which appears to be declining. The Fed's preferred inflation measure, the personal consumption expenditures index (PCE) showed core prices gained in July by just 0.1% month-on-month, compared with a 0.6% increase in June. The headline rate, which includes food and energy prices, fell 0.1% on the month and its year-on-year rate slowed from 6.8% to 6.3%. Although encouraging, Powell said the improvement "falls far short" of what the Fed "will need to see before we are confident that inflation is moving down."

Inflation is being led lower by fallings goods prices, for instance used car prices which were one of the key culprits in 2021. Retailers are discounting prices to move unwanted inventories. With the lifting of Covid restrictions, consumers have shifted their expenditure from goods to services. Goods inflation is dropping but services inflation remains elevated. The services sector has an outsized impact on the CPI basket. Meanwhile, rents and wages historically only trend lower 1-2 years after the respective peaks in inflation and home prices. Rents have a significant 40% weighting in the core CPI index. While inflation will fall over coming months some believe the decline will be far slower than its increase between 2020-2022.

The inflation debate rages on. Mohammed El-Erian, the chief economic adviser at Allianz is extremely critical of the Fed, which he accuses of being "asleep at the wheel", failing to analyse, failing to communicate and failing to implement the right policy. As a result, he believes it will take some time before the Fed gets inflation under control. Others including past US Treasury Secretary Larry Summers, who warned the Fed of its policy error in early 2021, believe the US will need to undergo a significant increase in unemployment to bring inflation back to its 2% target.

Others believe the market is too fixated on demand-side factors such as monetary and fiscal policy, business and consumer spending. The shocks of the pandemic and the Ukraine war suggest supply-side economics hold the key. Capital Economics chief US economist Paul Ashworth feels the answer might lie in the impact the supply shock has had on the supply curve. According to his framework, when output is below potential (without supply shocks) shifts in demand create potentially large changes in output but relatively small changes in price. But when output reaches potential (with supply shocks), shifts in demand generate small changes in output but potentially large changes in price. According to the framework, this can work in both directions, which means "it may only take a modest fall in demand to produce a significant drop back in price inflation." This more favourable outlook benefits further from the easing of supply chains. The sharp decline in shipping container rates suggest supply chains are being repaired.

Before Powell's Jackson Hole speech, fed funds futures predicted the fed funds rate would peak at 3.3% in early 2023. After the speech they predicted a peak rate of 3.8% at the end of May 2023. Having successfully lifted market expectations, the Fed will probably be able to strike a more balanced chord at the next policy meeting. In the meantime, market watchers should keep a close eye on longer-dated interest rates. The all-important US 10-year Treasury bond yield is a fraction above 3%, and its spread above the 10-year Treasury Inflation Protected Security (TIPS) real yield is 2.6%, equating to the market's predicted average inflation rate over the next 10 years. Longer dated interest rates appear well behaved for the time being but require close monitoring, lest they cause the apples to drop from the tree.

Local Report

Gielie Fourie

FATF, FICA, GRAY RHINOS, and GREY LISTING

INTRODUCTION: Michele Wucker's 2016 book, "The Gray Rhino", is the best-selling English language book in China. The subtitle of the book is: "How to Recognize and Act on the Obvious Dangers We Ignore". What is a Gray Rhino? A Gray Rhino is a highly probable, high impact, yet neglected threat. Gray Rhino disasters occur after a series of clear warnings and visible evidence. Black Swans, from the 2007 book by Nassim Taleb, on the other hand, are completely unforeseeable and unpredictable events. The book, The Gray Rhino, is shaping China's planning and policies for the future. To help them make better decisions, "The Gray Rhino" should be required reading for our politicians.

SOUTH AFRICA'S GRAY RHINO: South Africa's Gray Rhino is the danger of being grey listed by the FATF (see below). We have been warned for many years now, but there is a total lack of action from government. We have had so much corruption at the highest levels, but zero action. Even our president's reputation has been tarnished with large sums of dollars hidden in furniture on one of his farms.

FICA: In 2001, the South African government introduced the Financial Intelligence Centre Act (FICA) and other applicable Anti Money Laundering (AML) and Countering of the Financing of Terrorism legislation to combat money laundering and the financing of terrorism. We all hate FICA with passion. What is the origin of FICA? Let us look.

FATF: The Financial Action Task Force (on Money Laundering) (FATF) is a global intergovernmental organisation founded in 1989 on the initiative of the G7 countries to develop policies to combat money laundering. The G7 economies are Canada, France, Germany, Italy, Japan, the United Kingdom, the United States, and the European Union. The FATF is based in Paris. Following the September 11 terror attacks in 2001, the FATF was also charged with combatting terrorist financing.

FATF 40: In 1990 the FATF' published a set of Forty Recommendations (FATF 40) on money laundering. Later, nine Recommendations on Terrorist Financing (TF) were added. The Recommendations (FATF 40) are globally seen as the world standard in anti-money laundering. The FATF has been highly successful in getting its policies adopted worldwide. Many countries have made a commitment to put the Forty Recommendations in place. South Africa is one of the member countries – that is why we have FICA.

FATF GREY LIST: The FATF maintains a FATF Blacklist and a FATF Grey List for countries believed to be non-cooperative or non-compliant with the FATF 40. Currently Iran and North Korea are on the Blacklist. There are twenty-three countries on the Grey List. The FATF is not satisfied with South Africa's adherence to its 40 Recommendations and has warned us to get our house in order before April 2023. The consequences of being grey listed are significant: fines, business restrictions and being shut out from financial markets. We can expect higher costs for compliance and auditing, more inspections, being placed on the EU Blacklist, higher borrowing costs, cross-border transactions will be restricted, hampering imports and exports, and a multitude of other restrictions. Foreign countries will be discouraged from investing in South Africa. South Africa will suffer massive reputational damage. Standard Bank CEO, Sim Tshabalala, says the effect of grey listing would be worse than a sovereign credit downgrade. Ninety-One CEO, Hendrik du Toit, also warns of dire consequences if SA joins the Grey List – he describes it as 'another tax on incompetence'.

THE FATF TIMELINE: The FATF assessment of South Africa started in 2019. On 7 October 2021, the FATF published its final 230+ page report. We were found to be compliant with only three of the FATF 40 recommendations – a dismal performance. We were required to report back to the FATF within one year, before 7 October 2022. The FATF will then have a period of six months, to 7 April 2023, to review our report and report back to us.

WHAT OUR BANKERS SAY: The SARB governor, Lesetja Kganyago, says he is confident that we will avoid being grey listed. Our bankers are not convinced. Standard Bank CEO, Sim Tshabalala, says South Africa is "very likely to be grey listed" despite efforts by the Treasury. Nedbank CEO, Mike Brown, and two Capitec executives, have the same view. Last year (2021) South African banks reported 394,000 suspicious transactions and 4.85 million cash transactions, each larger than R25,000.00, to FICA. An analysis showed that 8,388 clients of one of our large banks had unknown citizenships. That bank clearly does not have the extremely basic "Know Your Client" (KYC) procedures in place. This is completely unacceptable. Earlier in August one of our big banks was fined R35 million by the SARB for non-compliance. If you think compliance is expensive, try non-compliance.

BOTTOM LINE: Government must report back to the FATF before 7 October 2022. It has only September 2022 left to prepare and pass the necessary legislation to satisfy the FATF. This is the final countdown, and we are running out of time. We have seen this big Gray Rhino storming in our direction for at least ten years, mainly in the form of widespread corruption. Government has been warned, yet it chose to ignore it at their peril. The buck stops at the FATF, which will announce its findings and decision in April 2023. The last thing South Africa needs right now is another obstacle to doing business internationally.