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WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 13 September 2022

Global Report

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Long-term inflationary trends

Inflation is the biggest threat in today's world economy and to global financial markets. In July, UK consumer inflation hit a fresh 40-year high of 10.1% year-on-year. In the Eurozone it also increased to a new peak of 9.1%. In the US, inflation appears to be past its peak. It fell on an annual basis from 9.1% in June to 8.5% in July. The prices of retail goods, hotel rooms, air fares, used cars and gasoline are all declining. Rents, which have a large weighting in the core CPI index that excludes food and energy prices, have stopped rising. Financial markets appear confident that inflation will fall steadily from here back to central bank targets, assisted by base effects and tight monetary policy.

US inflation is predicted to average 2.42% over the next 10 years, just above the Federal Reserve's 2% target. This figure is equal to the "Breakeven Inflation Rate," which is the difference between the nominal yield on the conventional 10-year US Treasury bond and the real yield on 10-year US Treasury Inflation Protected Securities (TIPS). It represents the bond market's prediction of annual inflation and adjusts according to any new information. The current breakeven rate of 2.42% may be excessively optimistic given the starting point of 8.5%.

The breakeven rate captures all immediate data and short-term information, but the longer-term inflationary trends deserve equal attention. Major geopolitical, demographic, financial and technological forces exerted major downward pressure on inflation in the three decades to 2020. The fall of the Berlin Wall in 1989 ushered in the end of the Cold War and a global peace dividend, promoting global trade and cross border mobility of capital, labour, and technology. The globalisation process accelerated further with China's admission to the World Trade Organisation in 2001. According to Capital Economics, global goods exports increased as a percentage of world GDP from 20% to 30% in the three decades to 2020, and between 1990 and 2018 there was a fivefold increase in cross border bond and equity flows and sevenfold increase in foreign direct investment flows. Globalisation led to increased competition. Ed Yardeni wrote that "Competition is inherently deflationary. No one can raise their price in a competitive market." Meanwhile, labour supply surged with the integration of the Soviet States and China into the world economy driving down wage inflation. As inflation fell so did interest rates and the supply of cheap credit, which fed into new technology and production capacity, driving inflation lower still.

The virtuous circle of globalisation, growing prosperity and falling inflation is being broken by the decoupling between the West, and Russia and China. Some analysts even say that the world has already descended into a Cold War 2.0. Protectionist trade policies and tariffs are the new order of the day, while the Covid pandemic has encouraged the reshoring of production to avoid potential future supply chain disruptions. Deglobalisation will limit competition and reverse the deflationary forces of the past three decades. The Covid pandemic has exacerbated the shortage of labour, but the impact of migration restrictions and an ageing world population are longer-term trends which will add to the scarcity of labour and drive wage inflation.

Climate change is inflationary. The race towards renewable energy has left carbon energy sectors dangerously under-invested, contributing to the surge in oil, coal, and gas prices. Renewable energy is not yet as economical as fossil energy and will require massive investment, increasing the scarcity of commodities. The growing severity and frequency of hot weather and droughts is affecting food prices but also hydroelectricity output, which accounted for 16% of the world's electricity in 2021, more than all other renewable energy combined. River and dam levels have dropped across the US, Europe, and China. China's Yangtze River fell in August to its lowest since the 19th century, prompting the Sichuan Province to ration power across 19 cities. Norway, the largest producer of hydroelectricity in Europe has warned it may have to reduce electricity exports over coming months. Severe droughts in India have led its government to impose controls over rice exports. India contributes 40% of the global trade in rice.

War is always the worst culprit. The Ukraine war is largely responsible for the food and energy price crisis affecting the world and in particular Europe. Europe and the UK are expected to face an energy crisis over the coming winter. ECR research observes that US consumer inflation rose steadily during the American Civil War to 11% in 1862, 23% in 1863 and 27% in 1864. In 1917 and 1918, inflation exceeded 17% and peaked at almost 11% during WW2.

The world has been through repeated cycles of globalisation and deglobalisation. The period between 1870 and 1914 was marked by tariff reductions, railway and shipping innovations, and global cooperation, which increased the share of global goods exports from 5% to 10% of world GDP. The wave of globalisation from 1989 involved so much more integration than the previous wave between 1945 and the early 1970s, that its unravelling will impact far more than just the trade in goods. The exchange and transfer of services, finance and technology will also be affected, having a potentially more damaging impact on the global economy and inflation than previous deglobalisation cycles.

Investors are anticipating that US inflation has already peaked and will drop back towards the Fed's 2% target. Inflation in Europe and the UK is expected to follow the US lead. Any evidence that inflation is not returning to normal as quickly and sustainably as expected would amount to a risk-off event for financial markets. Geopolitics could upset the optimistic inflation outlook.

Local Report

Gielie Fourie

GDP figures for Quarter 2 of 2022

GROWTH INTERRUPTED: In quarter one of 2022 (Q1 2022) our Gross Domestic Product (GDP) recovered to pre-pandemic levels. GDP growth for Q2 2022 was -0.7% Quarter on Quarter (QoQ) seasonally adjusted. The devastating floods in KwaZulu-Natal and loadshedding contributed to a decline in our GDP, weakening an already fragile economy. The size of our economy in Q2 2022 was smaller than pre-pandemic levels. Growth has been interrupted. But it is not the end of the world.

Year on Year (YoY) GDP growth for Q2 2022 was disappointing at only 0.2% seasonally adjusted, despite further expansion in private sector fixed investment - gross fixed capital formation grew by 0.5% in Q2 2022. GDP growth for 2022 is expected to be slightly below 2%, with slightly softer growth likely in 2023 given the widely expected global slowdown. GDP is calculated from data gathered from ten industries. The ten industries are grouped into three sectors: the primary sector, the secondary sector, and the tertiary sector. We look at the three sectors and the ten industries they represent.

THE PRIMARY SECTOR DRAGGED OUR ECONOMY DOWN: (1) Agriculture - QoQ growth seasonally adjusted -7.7%. The contraction was, according to Stats SA, mainly in respect of animal products. There is concern about the impact that the ban on the transportation of cattle, caused by foot-and-mouth disease, will ultimately have if it persists. In Q2 2022, real (seasonally adjusted) GDP was 3.5% below its Q1 2020 level in this sector. (2) Mining - QoQ growth seasonally adjusted -3.5%. This decline was dominated by gold, coal, and diamonds. Apart from the floods, persistent logistical (port/railway) challenges and electricity loadshedding constrains output in this sector, notwithstanding still relatively supportive prices in Q2 2022.

THE SECONDARY SECTOR – ALL THREE INDUSTRIES CONTRACTED: (3) Manufacturing - QoQ growth seasonally adjusted -5.9%. Petroleum and chemical products as well as food and beverages (in other words energy and food) were the biggest drags on manufacturing production in Q2 2022. The Manufacturing Purchasing Managers Index (PMI) for August 2022 was reported at 52 points, above the neutral 50.0 points mark that divides expansion from contraction, implying expansion in this sector in Q3 2022. Unfortunately, the worsening global outlook with PMIs of below 50, as well as persistent electricity loadshedding risk clouds the sector's prognosis. (4) Utilities - QoQ growth seasonally adjusted -1.2%. The consumption of both electricity and water declined in Q2 2022. After a notable improvement in electricity supply in August, Eskom has introduced stage four loadshedding in September. (5) Construction - QoQ growth seasonally adjusted -2.4%. Construction is the smallest industry in South Africa. This sector is still by far the furthest from a recovery to its pre-pandemic real GDP level – it was 21.6% below its Q1 2020 real (seasonally adjusted) GDP level in Q2 2022, with decreased activity reported for residential buildings as well as construction works. It is disappointing that government's promises of infrastructure development did not materialise.

THE TERTIARY SECTOR: (6) Trade, catering, and accommodation - QoQ growth seasonally adjusted -1.5%. This contraction stemmed from a decrease in economic activity in wholesale as well as retail trade in Q2 2022. Loadshedding has weighed on the wholesale sector. Real retail trade has been suppressed by a spike in inflation, delayed social grant payments and the delay with the government wage settlement. According to Standard Bank a recovery in employment, wages, and credit, as well as a boost from investment income keep the outlook for consumers relatively positive. (7) Transport and communication - QoQ growth seasonally adjusted 2.4%. This sector's output was boosted by land transport and transport support services as well as communication services in Q2 2022. Growth was better than expected by analysts.

(8) Finance and business services - QoQ growth seasonally adjusted 2.4%. Finance is the largest industry in South Africa. It grew faster than analysts' expectations. The growth in the sector was attributable to financial intermediation, insurance, and pension funding, as well as activities auxiliary to financial intermediation. (9) Personal services - QoQ growth seasonally adjusted 0.1%. Stats SA noted increased economic activity for community and other producers. Despite lacklustre growth in Q2 2022, this is still the non-agricultural sector that has performed best since the start of the pandemic, with real (seasonally adjusted) GDP by Q2 2022, nearly 6.6% higher than in Q1 2020 (prior to the pandemic and lockdown). (10) Government - QoQ growth seasonally adjusted -1.4%. This

contraction was owing to a decline in employment; it is a reversal of the 1.4% QoQ expansion in the preceding quarter.

BOTTOM LINE: Only three of the ten industries recorded growth – a contraction in GDP was thus inevitable. The net effect was a GDP contraction of 0.7%. Despite this contraction our unemployment rate has dropped marginally from 34.5% in Q1 2022 to 33.9% in Q2 2022. With the USA in a technical recession and Germany, France, Italy, and Spain having all had their growth forecasts downgraded by the International Monetary Fund, our QoQ GDP contraction of 0.7% seasonally adjusted is tolerable.

Where will growth come from? We do not expect global demand to be the main driver of our economy. Our Current Account Balance for Q2 2022, reported just last week, echoes this. It was a shocker at -R87 billion – it was expected to be R100 billion. We will have to depend on local demand to drive growth – but consumers' disposable income is under pressure from rising inflation and rising interest rates. It is going to be a hard year. We expect GDP growth of just below 2% this year. We simply must push up production to grow this economy. We cannot afford to have growth interrupted.