**OVERBERG MARKET REPORT**

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Global Report

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Inverted yield curves and recessions

Whether a recession occurs in the US ultimately depends on how much more the Federal Reserve hikes interest rates and that depends on how inflation behaves. January's nonfarm payroll report, although good news for short-term growth, with unemployment falling to a new long-term low of 3.4%, caused alarm among inflation watchers. Although strong payrolls are good for growth, they are less good for inflation and so the Fed may be more inclined to lift the fed funds rate by another 50 rather than 25 basis points. The last 2-3 rate hikes are always the most painful, as by then the fed funds rate is closer to the neutral level, and in danger of moving into restrictive territory.

As things stand, the yield curve is telling us that the Fed has already pushed the fed funds rate into restrictive territory and that a recession is inevitable. Curve inversions tend to occur when central banks lift interest rates, which push up short-dated (2-year) bond yields while supressing longer-dated (10-year) bond yields, as markets project declining inflation and growth. Recessions typically occur around 12 months after a yield curve inverts. The yield curve has been inverted since July, with the 2-year yield trading at one stage last week at an 86 basis-point premium to the 10-year Treasury yield. This is the biggest inversion since 1981 when US CPI was above 10% and the fed funds rate under Fed Chair Paul Volcker was around 19%.

Should we be alarmed? When predicting recessions, yield curve inversion has a good track record, but it is not infallible. As the saying goes, yield curve inversions have predicted 12 of the last 10 recessions. A false alarm was sounded in 1994. Many economists believe there is no imminent US recession on the horizon.

One reason is that bond yields have been heavily distorted by the exceptional central bank quantitative easing unleashed during 2020 and 2021 to save the world economy from the Covid pandemic. Record levels of central bank asset purchases have reduced the amount of bonds that are available for trading. Moreover, asset purchases were concentrated at the long end of the bond yield curve. The Fed owns around 30% of all outstanding Treasury debt. Studies show that in the absence of the Fed's QE purchases, the 2-10-year yield curve would be 100 basis points more positive. At the same time, increased regulatory requirements demand ever greater collateral, which drives buying of longer-dated Treasury bonds and exacerbates the shortage.

Economic fundamentals are far more robust than the inverted yield curve would suggest. Households in the US are still sitting on over $1 trillion of excess savings accumulated during the pandemic-era handouts. Even before the handouts, household balance sheets were in rude health after a more than decadelong period of deleveraging post the 2008/09 Global Financial Crisis. Companies and banks also deleveraged. Private sector balance sheets can cope with raised interest rates. Other economic tailwinds include full employment and strong wage growth, which boost household disposable income, that is further benefited by falling inflation.

There is also a powerful global effect. China, the world's second largest economy, is reaccelerating after abruptly abandoning its Covid restrictions. China's GDP is expected to grow by 5% this year compared with 3% last year. In Europe, plunging energy prices are reigniting growth momentum. Independent research firm, Cross Border Capital, highlights two of its daily data series. The first monitors economic surprises versus consensus expectations. The second uses an algorithm to assess GDP implications from movements in trade-sensitive currencies, commodity prices and corporate credits. "Both concur that there has been a recent acceleration in world economic growth, even back to the 3% level last recorded in 2020."

Despite evidence to the contrary, other economists feel that a recession is inevitable. They cite the lagged impact of interest rate increases. With a lag of 6-12 months, interest rates will take time to reverberate through the economy. They also point out that pandemic-era excess savings will soon be depleted. Yet even these economists have been surprised by the strength of economic activity so far and admit that although a recession is inevitable, it will also be mild and short-lived. It may last as little as 6 months, in which case, since share prices discount events in advance, equity markets will probably look straight through the recession to the expected recovery on the other side.

The current yield curve inversion may correctly predict an upcoming recession but supply and demand distortions to the US Treasury bond market mean that the scale of the recession is unlikely to mirror the biggest curve inversion since 1981.

## Local Report

Gielie Fourie

### Private equity

INTRODUCTION: On the Johannesburg Stock Exchange (JSE) the number of listed companies is shrinking slowly, while at the same time the market capitalisation of the JSE is growing fast. In short, less is more - we are left with less companies, but with more value. It has been happening in slow motion — so slow you may not even have noticed. In 2003 the JSE had an estimated 473 listed companies – now we have around 325 companies left – 148 companies (31.2%) have delisted. See the graph below. During the same period, the market capitalisation of listed companies increased from US$182.6 billion to US$1.36 trillion in March 2022. An increase of 645%.

The number of firms listed in the world's largest economy – the US – is shrinking as well and has been shrinking for some time. The total number of US listed companies has fallen by nearly 40% since 1997. The Wilshire 5,000 Index – one of the broadest representations of the US market – was established in 1974. It was named for the approximate number of companies included in the index, namely 5,000. As of March 31, 2022, the index contained only 3,660 companies, a drop of 1,240 companies. While the US markets are shrinking, the market capitalisation of US listed companies has been rising steadily.

We can postulate from this that the average market capitalisation of listed companies has increased. An ever-decreasing number of mega big firms dominate stock markets. It is not an ideal trend, as fewer larger firms lead to less corporate discipline and weaker shareholder democracy. Some refer to it as the "oligopolisation" of the economy, where few powerful companies exert undue control on the market. (Killik & Co Investment Management, London). The total number of companies listed globally has never been higher than today, thanks largely to the rapid expansion of stock exchanges in Emerging Markets.

Why is this happening, why are markets shrinking? The key factor is simply that fewer firms want to be listed. Some entrepreneurs fear the level of regulation and media scrutiny that comes with listing. With fewer companies to pick from, investors, and asset managers, struggle to achieve balanced, diversified portfolios that truly represent the underlying economy. What started as a trend in the world's largest market – the US – will inevitably ripple out to other bourses, particularly the older, more established ones.

A first spinoff of this trend:  Reliance on broad indices as a full representation of the underlying economy looks increasingly unwise, especially in the US. A second spinoff: This trend underscores the importance of international portfolio diversification to ensure that an investor is not inadvertently over-exposed to the listed firms that increasingly dominate Western bourses. The historical reason for listing a company on a stock exchange is the opportunity it offers to raise capital. However, there are now CEOs who simply do not see the point of listing when they can raise capital from private equity and venture capital firms instead, far away from public markets and away from the costs and regulations associated with listing.

ENTER PRIVATE EQUITY: In South Africa and the US combined, more than 3,800 companies have delisted over a period of 50 years. Many of them were profitable small or micro capitalisation companies. This universe of small unlisted companies is regulated by the companies act but escapes the regulations of stock exchanges. This puts them legally out of reach for asset managers. Asset managers need small companies in their portfolios – some have excellent growth potential. There is a way out for asset managers. Listed companies are allowed to invest in unlisted companies. Private equity refers to investment companies that buy and manage small unlisted companies.

ETHOS: On the JSE there is a successful specialist private equity company, EPE Capital Partners Ltd ("Ethos Capital"). Ethos is the largest private equity firm in sub-Saharan Africa. Ethos has investments in several companies. Companies that you may recognise are Twinsaver (toilet and tissue paper), Primedia (premium radio stations like 947, 702, Kfm 94.5, CapeTalk, and Eyewitness News), RTT (a courier company), and AutoZone (vehicle parts). They are all unlisted companies.

REINET: The Rupert family's investment vehicle is operating as a private equity fund. Reinet's largest unlisted investment, Pension Corp, has been a decent performer. €1.315bn invested over the years has more than doubled to €2.65bn. Pension Corp represents 50% of Reinet's Net Asset Value (NAV). Reinet's second biggest investment is in BATS, valued at around €1.8bn. BATS is Reinet's cash cow. Besides the millions Reinet receives in dividends, Reinet also sells BATS shares when it needs cash. Smaller unlisted investments include Nano Dimension (the pioneer of 3D Printing), Soho China Property, GAM Real Estate (invests across Western Europe, especially in the United Kingdom). Smaller investments in private equity now account for about 18% of Reinet's NAV. Johan Rupert has made excellent investments in the past. He is looking for the next big one. It will take time. Rupert knows: The day you plant the seed is not the day you eat the fruit.

BRAIT: Brait is an investment holding company focused on driving sustainable long-term growth and value creation in its investment portfolio of sizeable unlisted businesses operating in the broad consumer sector. The current investment portfolio includes New Look (ladies' fashion brands), Virgin Active (health clubs), Premier (mainly packaged food) and Iceland Foods (frozen foods).

BOTTOM LINE: An unintended consequence of shrinking stock markets was the birth of Private Equity. Unlisted companies had a need for funding and leadership without the compliance intricacies of a stock exchange. Private equity allowed asset managers access to the pockets of excellence in the small capitalisation universe. All big companies were once small companies. Having exposure to small caps can be very profitable. Tencent, now the biggest company in China, was started in a small building. Ignore small companies to your peril. To find out more, contact one of our consultants for a gratis consultation.

The shrinking JSE. The number of listed companies on the JSE.


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