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WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

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Is disinflation transitory?

Inflation is everything in current financial markets. It was the surge in inflation and interest rates that followed the Covid pandemic due to supply chain disruptions, pent up demand and household balance sheets replete with government handouts, which caused last year's collapse in global financial markets. US CPI surged to a peak of 9.1% in June 2022. As the Federal Reserve abandoned its 2021 mantra that the inflation spike was "transitory", the fed funds rate increased over the year from zero percent to 4.25-4.50%, its fastest rise since the 1980s. At the longer end of the interest rate spectrum, the all-important 10-year US Treasury bond yield, against which financial assets are priced, reached a peak of 4.23% in October compared with 1.49% at the start of the year. The S&P 500 index lost 19.4% over the year. The MSCI World index lost 19.8%.

The rebound in financial markets since their low point last October is attributed primarily to the move past peak inflation, peak bond yields and peak central bank hawkishness. US CPI has been on a steady downtrend since peaking at 9.1% in June, allowing the Fed to temper its interest rate outlook and bond yields to stabilise. However, January's CPI data was disappointing. Year-on-year (y/y) headline CPI slowed only slightly from 6.5% to 6.4%. Month-on-month (m/m) it increased by 0.5% compared with 0.1% in December. Energy was partly to blame, it increased by 2.0% m/m, but core inflation, which excludes food and energy, did not fare much better. It reduced only slightly y/y from 5.7% to 5.6% and m/m remained at 0.4% unchanged from December's figure. Even core goods prices, where recent deflation has contributed to the CPI downtrend, returned to a positive 0.1% m/m gain.

The inflation doves cite the January effect. Suppliers hike prices at the start of the year, especially if there is a potential recession around the corner. It might be their last opportunity to hike prices for a while. The doves also point out that rental inflation, which comprises over 40% of core CPI, is expected to fall sharply as the lagged measure used to calculate inflation catches up with present-day declines. Zillow's index of new leases fell in December at a 3-month annualised rate of 3%, in sharp contrast with January's 7.9% y/y housing CPI figure. The inflation hawks argue that inflation will remain sticky until there is an increase in unemployment. Nonfarm payrolls surged by 517,000 in January pushing unemployment down to 3.4% its lowest since 1969. Wage growth, although reducing slightly remained elevated at 4.4% y/y but the inflation doves point out that productivity is also improving rapidly. Productivity gained in the fourth quarter 2022 by 3.0% annualised, so that despite rapid wage growth, unit labour costs only increased by 1.1%.

The inflation hawks question how long repaired supply chains will result in lower goods prices. Dallas Fed leader, Ms. Logan, said goods price declines were not sustainable as "supply chains can't recover twice." The hawks are also anxious about services inflation, where wage pressures have the greatest impact. They look closely, as does the Fed, at core services inflation excluding housing, as it strips out the anticipated decline in rentals. The m/m reading improved from 0.4% in December to 0.3% in January, but the better reading is dismissed due to the 0.7% once-off seasonal decline in medical care services inflation. As this component normalises, core services inflation could start picking up again. According to independent research firm, MRB Partners, "The trend of wage growth implies that non-rent services inflation (the key underlying driver of US inflation cycles) will remain persistently high ahead."

Resilient economic data adds to the feeling that the inflation hawks may be winning the debate. The inflation doves, which have been predicting a recession, albeit mild and short-lived, admit they are surprised by the strength of economic activity. January's nonfarm payrolls were incredibly strong. Retail sales were sharply higher in January, rising by an astonishing 3.0% m/m. The NFIB Small Business Association remains positive on companies' prospects with hirings and final sales indices at historically high levels. The US Homebuilders' monthly report has shown sequential gains in expected sales over the past few months despite the surge in interest rates.

There is a compelling argument that despite its fastest increase since the 1980s, the fed funds rate is still not in restrictive territory. This is due largely to the strengthening in household, corporate and bank balance sheets in the decade of deleveraging that followed the 2008/09 Global Financial Crisis. In the absence of structural imbalances, the US private sector is able to cope with higher interest rates.

MRB Partners agree that inflation will continue declining over the next 6 months or so, which will support financial markets over this period provided bond markets remain stable. After that however, MRB says inflation will struggle to get below the 3.5% level and down to the Fed's 2% target unless there is a full-blown recession. This implies that after pausing its interest rate hiking cycle, the Fed's next pivot will be further rate hikes rather than the mainstream expectation that rates will fall by year-end and into 2024.

US Consumer Prices

	All Items		Excl Energy & Food		Energy	Core Goods	Core Services	Core Services Ex Housing
	%m/m	%y/y	%m/m	%y/y	%m/m	%m/m	%m/m	%m/m
Nov	0.2	7.1	0.3	6.0	-1.4	-0.2	0.5	0.2
Dec	0.1	6.5	0.4	5.7	-3.1	-0.1	0.6	0.4
Jan	**0.5**	**6.4**	**0.4**	**5.6**	**2.0**	**0.1**	**0.5**	**0.3**

Source: Capital Economics

Local Report

Gielie Fourie

Banks overview

INTRODUCTION: The banking sector is one of the most exciting and rewarding industries to invest in. It is also one of the most profitable sectors, with many banks posting double-digit returns on equity.

Our five biggest banks all generate double digit returns on equity. Banks have a strong influence on the economy, and their shares can serve as a great way to diversify your portfolio. The banking sector is a good choice for value investors. The perspective of a value investor can be better understood through Benjamin Graham's description of the stock market as a voting machine in the short term, but a weighing machine in the long term. The meaning of this metaphor is in the near term, stock prices are determined by the emotions and opinions of market participants. But in the long term, the price is driven by the actual performance of the business. Value investors are drawn to bank stocks.

The South African retail banking sector is characterised, and protected, by high barriers to entry. The sector is concentrated, with four of the largest banks – Standard Bank, Absa, First National Bank and Nedbank – accounting for more than 80% of retail deposits. The most successful new entrant into the local market, which took market share from the big four, has been Capitec in 2001. Below are the five biggest banks in South Africa in order from the oldest to the youngest.

STANDARD BANK: Standard Bank was South Africa's first bank. It was established long before the SA Reserve Bank was established in 1921. Standard Bank's origins can be traced to 1862, when a group of businesspeople, led by the prominent South African politician John Paterson, formed a bank in London, initially under the name Standard Bank of British South Africa. In 2022 it acquired 100% of Liberty Life, after which Liberty delisted. Standard Bank clearly saw the value that Liberty could add to their business strategically as a life insurer and asset management business. The integration of Liberty was executed better than expected. Standard Bank has a 5-year earnings per share (EPS) compounded annual growth rate (CAGR) of 2%. Its 5-year average return on equity (ROE) is 13.9%.

NEDBANK: Nedbank was formed in 1888. The Nedbank Group was formed from the merger of Syfrets SA, Union Acceptances and Nedbank in 1973. Old Mutual owned a 52% stake in Nedbank, from 1986 until 2018. Old Mutual unbundled the majority of its 52% stake in Nedbank to Old Mutual shareholders in 2018. Old Mutual still owns around 7% of Nedbank. Nedbank's market capitalisation today is more than double that of Old Mutual (R118 billion vs R56 billion). Nedbank has a 5-year EPS CAGR of 1%. Its 5-year average ROE is 12.2%.

FIRSTRAND: FirstRand, previously Barclays Bank, was formed in 1925. The FirstRand Group was established in 1998, by the merger of First National Bank of South Africa, Rand Merchant Bank and Momentum Insurance & Asset Management. FirstRand has a 5-year EPS CAGR of 4%. Its 5-year average ROE is 20.0%. It is the top bank pick of PSG. We hold FirstRand in our portfolios.

ABSA: Volkskas was formed in 1935. Amalgamated Banks of South Africa Limited (Absa) was formed in 1991 through the merger of UBS Holdings, the Allied and Volkskas Groups, and certain interests of the Sage Group. Absa has a 5-year EPS CAGR of 4%. Its 5-year average ROE is 11.8%.

CAPITEC: Capitec was formed in 2001, just 22 years ago, by the entrepreneur Jannie Mouton, founder of the PSG Group, through the acquisition of micro-lending businesses. Competition from big banks makes it difficult to start a new bank. The competitive environment for Capitec was boosted by regulatory and policy changes that sought to make the playing field more open and level. The 2008 Banking Enquiry focused attention on retail banking and heightened awareness about competitive behaviour in the sector. Capitec's timing was spot on. Capitec has a 5-year EPS CAGR of 17%. Its 5-year average ROE is 24.0%.

EXPANDING INTO AFRICA: Capitec has experienced phenomenal growth without venturing into Africa. The four big banks all expanded into Africa, with mixed results. They all expect to report increased credit impairments stemming from Ghana's sovereign debt crisis. Ghana has defaulted on its foreign debt and is in talks with the IMF to restructure its debt. In a SENS announcement on Friday, 17 February 2023, Absa stated: "We expect our credit impairments to increase significantly year-on-year, mainly due to impairments on sovereign investment securities." In this financial year, in Ghana alone, Absa's earnings will be negatively impacted by 36%, Standard Bank by 16%, Nedbank by 9% and FirstRand by 2%. Capitec has no exposure. It achieved tremendous success by staying local.

BOTTOM LINE: The regulatory environment and high capital requirements serve as a moat for the banking industry. History proves that banks can survive for centuries. Banks are sound investments, have long lifespans, provides good capital growth, and pay attractive dividends – see the table below. They also provide good diversification for your portfolio. Warren Buffett always has a spot in Berkshire Hathaway's portfolio for bank stocks. Buffett keeps about one-fifth, or $100 billion, of the portfolio invested in banks. You should invest in banks too, but not just any bank – do not try this at home. If South Africa is grey listed in March 2023, banks will be negatively affected. Contact one of our professional consultants for a gratis consultation.

Sources: PSG, Standard Bank, Absa.

Performance of the five biggest banks in South Africa

BANK	MARKET CAP	PRICE	P/E RATIO	PRICE:NAV	DIV/YIELD
FIRSTRAND	R364 336 245 665	R64.11	11.10	2.20	5.34%
STD BANK	R303 676 057 286	R179.05	10.12	1.37	6.04%
CAPITEC	R214 946 088 332	R1 762.41	22.56	5.80	2.07%
ABSA	R168 812 592 709	R190.36	8.16	1.23	5.69%
NEDBANK	R118 693 758 320	R227.55	8.61	1.10	7.04%