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WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

Nick Downing

Q2: Global Market Review

As expected, the shock of the mini-banking crisis faded over the second quarter (Q2) and the global economy picked up slight momentum. However, the economic cycle is highly unusual. The impact of the pandemic, the extraordinary fiscal and monetary stimulus that followed and then the Ukraine war, have created a vastly different economic cycle. Manufacturing is in recession around the world, but service sectors are flourishing. Investor anxiety alternates between looming recession on the one hand and sticky inflation on the other. Yet, economies have avoided the recession that many predicted at the start of the year and inflation is gradually easing, although at a slower than expected pace. Company earnings have continued to increase, providing an underpin to equity markets.

Nearly all equity markets posted positive returns in Q2. Japan's Nikkei 225 index was the regional outlier with an 18.36% return in Q2 and 27.19% for the year-to-date (YTD), as its economy benefitted from its recent Covid reopening and close trade ties with China's rebounding economy. The Bank of Japan is also alone in the world in providing generous monetary policy accommodation despite the country emerging from decades long deflation. The US S&P 500 index gained 8.30% in Q2 lifting its YTD return to 15.91%. The US benchmark is now up over 20% since its low point in October last year, qualifying as a "bull" market, confounding the sceptics at the start of the year with their prophecies of recession and doom. However, the uptrend has been driven by a remarkably limited number of shares, the seven technology giants that are being bid higher by the hype around artificial intelligence (AI). The S&P 500 would be down YTD if one excluded the seven technology names, Apple, Microsoft, Amazon, Alphabet, Tesla, Meta Platforms and Nvidia, which combined have a 28% weighting in the S&P 500.

Other markets fared less well. China's Shanghai & Shenzhen CSI 300 index lost 5.15% in Q2, erasing its Q1 gains with a YTD loss of 0.75%, due to disappointment over the rebound from Covid lockdowns. Yet, China's economy is still expected to achieve 5% growth in 2023, and while it will slow over the coming decade, will be growing at double the pace of developed economies. Its share of global GDP is projected to increase from 18% last year to 23% in ten years' time. Despite China's ageing population, the country is not yet fully urbanised. The United Nations forecasts that people living in cities with populations exceeding five million will increase from 208 million in 2020 to 280 million in 2030, bringing numerous economic spinoffs and considerable relief to the over-extended property sector. The UK's FTSE 100 index also underperformed, dragged lower by 1.31% in Q2 trimming its gain for the year to just 1.07%. The UK's over extended residential property market is in danger of protracted declines due to the sharp rise in mortgage interest rates. This danger ratcheted higher after the release of shock UK inflation data for the month of May. Core consumer price inflation (CPI) gained by 1.1% on the month, lifting the year-on-rate to 6.8% from 6.2% the previous month. This prompted the Bank of England to lift its benchmark interest rate by a hefty 50 basis points after two

25 basis point hikes in the previous two policy meetings, which as well as endangering the fragile property market may lead to further underperformance of UK based investments.

European markets, which were the top performers in Q1, were held back in Q2 by their lack of AI champions. Nonetheless, economic activity and earnings growth maintained positive momentum and the German Dax index managed a solid 3.32% gain in Q2, lifting its YTD return to 15.97%. The MSCI All Country World index was up 12.79% YTD after gaining a further 5.58% in Q2 despite half the companies in the index showing YTD losses, illustrating the outsized impact of mega-cap technology stocks. The MSCI Emerging Market index was up a relatively subdued 3.46% YTD and only 0.16% in Q2, due mainly to China's losses.

The World Bank Global Economic Prospects report published in June portrays a mixed picture of the global economy. The report warns that despite implementing the steepest increase in global interest rates in four decades, inflation remains stubbornly high. At the same time, global growth is expected to slow down. The World Bank predicts a slowing in global GDP growth from 3.1% in 2022 to 2.1% in 2023, inching up slightly to 2.4% in 2024. Notably however, the 2023 figure is an improvement of 0.4% on the World Bank's January report. Emerging market economies are expected to do better than advanced economies. China is expected to grow 5.6% in 2023 and 4.6% in 2024 and India by 6.3% and 6.4% respectively. Advanced economies are expected to grow by only 0.7% in 2023 and 1.2% the year after compared to 4% and 3.9% for emerging markets.

Emerging markets have dealt with the inflation threat more decisively. Rather than waiting to find out if the initial pick-up in inflation would be "transitory," they did not hesitate to hike interest rates and as a result monetary policy became restrictive far sooner. In emerging economies core inflation is already moving decisively lower while in developed economies the outlook for inflation remains far less certain. After a decade of below-target inflation readings in the pre-Covid era, significantly above target inflation has become a phenomenon in both Europe and the US. At its latest policy meeting on 14th June, the Federal Reserve paused its interest rate hiking cycle but cautioned that it would likely raise the fed funds rate again by a further 50 basis points by year-end, upending the consensus view that peak interest rates had already been reached. The strength of services inflation means CPI may take longer than previously expected to get back to central bank target levels, especially given the resilience of company and household balance sheets, full employment, and strong hiring intentions. The latest Manpower Employment Survey of large global companies showed an unexpectedly strong reading for Q3 hiring plans. Instead of moving lower, hiring intentions showed a meaningful improvement, undermining predictions of recession but at the same time signalling stickier than expected inflation.

Fortunately, inflation is still declining albeit at a gradual pace. In the US, CPI eased in May to 4.0% year-on-year from 4.9% the prior month. Core CPI, which excludes food and energy prices, slowed more slowly from 5.5% to 5.3%. The Fed is especially watchful of the Personal Consumption Expenditures Price Index, which in May eased very slightly to 4.6% on the year from 4.7% in April, but more encouragingly the three-month annualised rate dropped to 4.1%. The inflation hawks doubt inflation will return easily to the 2% target of developed economy central banks. However, even the hawks agree that inflation will come down from current levels.

Sticky inflation may be a key contributor to the global equity rally. Inflation lends pricing power to companies. During the first quarter in the US, 78% of companies representing the S&P 500 index beat consensus earnings forecasts and earnings projections are being revised higher. Global earnings expectations have been remarkably resilient this year despite recession fears. In fact, the global earnings revision ratio, measuring earnings upgrades versus downgrades as a share of total revisions,

has edged into positive territory. Since corporate revenue and profits are nominal variables, rising prices should help rather than hurt corporate profitability. Indeed, nominal GDP is a close proxy for corporate revenues. In a relatively high inflation environment, nominal GDP growth can remain positive even when an economy enters recession, especially if a recession is shallow and short-lived as most analysts are predicting. In the US, the recessions in the 1970s and 1980s were severe, but earnings per share drawdowns were much milder than those in recent decades when low inflation prevailed. Global investment research firm Alpine Macro makes a strong case: "Assuming a mild (US) recession reduces annualised real GDP to 0% and inflation falls by an additional 150 basis points by year-end, nominal GDP would still be growing at around 4%, which is the same as the average nominal growth rate during periods of normal economic expansion since the Global Financial Crisis. Moreover, operating earnings per share growth was 12.3% during this period."

The greater risk is a more significant economic slowdown in the US and Europe as suggested by the most inverted yield curves in the US and Germany since the early 1990s. However, the yield curve may well be sending a false alarm. Consumers are continuing to benefit from wage growth and accumulated savings to bolster spending, and companies have low levels of debt and strong pricing power. Companies have managed to maintain their margins despite rising input costs. They have been able to pass rising costs to consumers rather than absorb them in their margins. Private sector balance sheets for households and businesses are the healthiest they have been since the 1980s, making them more impervious to rising interest rates.

That said, central banks are unlikely to lift interest rates much further. Real interest rates are likely to move higher on their own as central bank rates are kept at current levels and inflation gradually declines. Monetary conditions will naturally tighten in the absence of further central bank rate hikes. Recessions in the US and Europe, if they occur at all, are likely to be shallow and short-lived, with stronger growth in emerging economies, especially China and India providing valuable support, and the rapid adoption of AI supporting a potential investment and productivity boom. This backdrop augurs well for global financial markets.

Local Report

Gielie Fourie

Q2: Local Market Review

LOW/NO ECONOMIC GROWTH: South Africa averted a mild technical recession in Quarter 1, 2023 (Q1 2023). A technical recession is defined as two consecutive quarters of negative Gross Domestic Product (GDP) growth. Q4 2022 returned quarter-on-quarter (Q-o-Q) negative growth of -1.1%. Q1 2023 returned a modest positive GDP growth of only 0.4%, thereby averting a technical recession by the slimmest of margins. The International Monetary Fund (IMF) reported that our near-term growth outlook has deteriorated. It is concerned that South Africa's economic and social challenges are mounting, risking stagnation amid significant increase in the intensity of power cuts. The IMF projected our Real GDP growth to decelerate sharply to 0.1% in 2023, lower than the optimistic 1.20% projection of Stats SA. This indicates that we cannot expect too much GDP growth for Q2 2023. GDP for the next four years is projected to be: 2024 (0.9%), 2025 (1.4%), 2026 (1.8%), and 2027 (2.1%).

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MARKETS OFFER VALUE: The JSE indices had mixed performances in Q2 2023. The JSE ALSI index was down by 0.10% and the Resource 10 index was down by 6.4%. On the positive side the Top 40 index was slightly up by 0.29%, the Industrial 25 index by 3.37% and the Financial 15 index by 3.62%. The JSE is trading at modest prices. The ZAR was on its backfoot during the quarter, losing against the USD (5.96%), the GBP (9.21%), and the EURO (6.75%). Share prices are in buying territory. The Prices/Earnings (PE) ratios are the lowest we have seen in the last ten years. The current PE ratio of the ALSI index is 9.77x – in Feb 2021 it was as high as 26.00x. The S&P 500 PE ratio is 25.76x, indicating a big margin of safety for the JSE. The JSE's dividend yield (DY) is 4.57% and the earnings yield (EY) is 10.23% - the S&P 500 EY is 3.88%. Overall the JSE offers value. "The best time to deploy capital is when things are going down." Warren Buffett.

POLICY OUTLOOK – INTEREST RATES: The general direction of global interest rate cycles remains a crucial factor for the SA Reserve Bank's (SARB's) Monetary Policy Committee (MPC) when determining local rates. With global central banks still keeping a tight grip on the current rate-hiking cycle, this may feed through to SA, which, as we know, has its own unique economic issues. Since November 2021, the SARB has hiked rates at ten consecutive meetings, adding 475 basis points (bps) in the cycle overall. Following better-than-expected inflation figures of 6.3% (Y-o-Y) from Stats SA in May, local market participants have begun to feel more confident that the SARB could pause interest rate hikes in July. But we must be realistic, rather than too optimistic. The latest overall tone and rhetoric from the SARB remains hawkish, suggesting a potential continuation of rate hikes. At the MPC meeting in May it hiked the repo rate by 50 bps. Importantly the vote was unanimous, indicating a hawkish MPC. The previous unanimous vote was ten meetings ago in September 2021. The SARB's standpoint, in line with other central banks, is that the policy rate will have to remain restrictive for longer to bring down inflation. SARB governor, Lesetja Kganyago, said in an interview with Bloomberg TV last week, it was too soon to tell whether the bank would pause its rate hiking cycle as the US Federal Reserve did in June.

INFLATION AND RISKS IN Q2 2023: Headline inflation is projected to fall back within the SARB's target range of 3% - 6% in the second half of 2023. Lower food and fuel price inflation and the SARB's less accommodative monetary policy stance are key factors behind this decline. Inflation is expected to reach the target range mid-point of 4.5% in 2024 and remain there through the medium term. While sticky food inflation has been giving consumers some indigestion lately, the May 2023 data brought a breath of fresh air. While food inflation remains high, May 2023 numbers provided a sharp decline from recent months and the first solid indication of a turnaround. This momentum is expected to persist over the coming months, with food inflation expected to continue trending downwards due to high base effects, the relative recovery in the rand's value over the past two weeks and the filtering through of recent lower producer prices to the retail level. The relative strength of the rand remains a key factor to watch, as the high-risk environment (both domestically and globally) could trigger sharp and volatile movements in the rand. Another sharp depreciation in the rand could again drive food prices higher and give consumers stomach-aches again.

POLITICS AND RUSSIA: The big question for many South Africans remains the same – what does this mean for us, given our government's problematic 'friendship' (or, in their words, 'neutrality') with Russia? If anything, recent events have further lowered the probability that the Russian president will attend August's BRICS Summit (to be held in SA) in person. This has been a critical sticking point and source of tension between SA and the international community, considering that the International Criminal Court (ICC) has issued an international arrest warrant for Putin, and SA is a signatory to the Rome Statute. The warrant is for alleged war crimes regarding the unlawful deportation of children from Ukraine to Russia. Whilst a formal political coup in Russia appears to have been averted (at

least for now), recent events seem to point to a weakening of Putin's traditionally authoritarian grip on power.

STRUCTURAL REFORMS: The IMF's mission to South Africa in March 2023 supports the government's objectives to reduce debt vulnerabilities and create the conditions for higher growth, as articulated in the 2023 Budget and the October 2022 Medium-Term Budget Policy statement (MTBPS). While the MTBPS and the recently tabled budget make provision for some risks and contingencies, risks to the fiscal outlook are substantial. South Africa's public debt is among the highest in emerging markets and is set to continue rising on current policies. This leaves limited fiscal space to respond to adverse shocks, including from contingent liabilities from State Owned Enterprises (SOEs), social spending needs, and climate events. It also exposes the government to increasing borrowing costs, diverting limited resources away from more productive capital and social spending.

Lastly, more reforms are needed to address South Africa's long-standing structural impediments to growth. Experiences in other countries suggest that successful implementation of structural reforms require a gradual and sustained approach, well-targeted compensatory measures conditional on reform implementation and with clear sunset clauses and timelines, leveraging of independent institutions, early engagement with stakeholders, and effective communications. In summary, reforms should aim at improving energy security, fostering private investment, promoting good governance, and creating jobs.

Please use this information as a reference, rather than as a basis for making investment decisions. To take the emotion out of equity analysis, you are welcome to contact one of our friendly consultants for a free consultation.

Sources: International Monetary Fund. Investec. Stats SA.

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