overberg
asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 25 July 2023

Global Report

Nick Downing

The Federal Reserve in 2024

The Federal Reserve concludes its policy meeting tomorrow on 26th July. The consensus forecast is that the Fed will hike the fed funds rate by 25 basis points to a range of 5.25-5.50%. It has been raised in almost record time from 0% in March 2022. Will tomorrow's rate hike be the last? A lot depends on where the equilibrium or neutral rate lies, defined as the real fed funds rate (after subtracting inflation) that neither stimulates not restricts the economy.

The level of the neutral fed funds rate is objective and open to fierce debate, especially now after such a rapid and substantial tightening in monetary policy. Economists are divided in two camps. One believes that the fed funds rate is already in restrictive territory and a recession is on the horizon due to the lagged impact of rate hikes so far. The other believes that rates are not yet restrictive, that a recession is not on the horizon and that the Fed will need to tighten more in order to beat inflation.

Independent global investment research firm, Alpine Macro, makes a compelling argument that the fed funds rate is already well above the neutral rate and macro trends are likely to keep the neutral rate low over the long-term. Alpine Macro cites the Federal Bank of New York's equilibrium rate model, which captures the effect of the Covid shock. According to the model the neutral rate has dropped to 0.6% which is below the pre-pandemic level, suggesting the fed funds rate is already around 2% above the neutral rate. Alpine Macro cautions that the Fed has no need to tighten further as real interest rates are already restrictive and inflation is coming down sharply. Headline US CPI has fallen from a peak of 9.1% in June 2022 to 3% in June 2023. Core CPI, which excludes food and energy prices, has dropped from a peak of 6.6% to 4.8%, a more modest reduction but if shelter is excluded core CPI would be 2.8%, close to the Fed's 2% inflation target. The shelter component of CPI lags the actual housing market which has already dropped.

If the fed funds rate is already restrictive and inflation keeps coming down, it is likely that the Fed will be cutting interest rates over the next two years. Independent economic research company, Capital Economics forecasts the fed funds rate will peak at 5.25-5.50% and drop to 3.25-3.50% by end 2024, dropping further to 2.50-2.75% by the end of 2025. The prospect of sharply declining interest rates will be welcomed by financial markets.

Alpine Macro argues that the neutral policy rate will remain compressed globally over coming decades across the world due to long-term demographic and productivity trends and rising global inequality, which are all reducing the trend economic growth rate and therefore dictate a lower neutral interest rate. As the world's population ages, the workforce is shrinking which reduces the potential economic growth rate. Productivity growth has been steadily tracking lower, which also reduces the potential economic growth rate and therefore commands a lower neutral interest rate. As global inequality

rises, a larger proportion of wealth flows to the rich who are inclined to save more, having a similarly depressing effect on economic potential. The IMF forecasts that equilibrium real interest rates are likely to stay close to pre-pandemic levels in advanced economies in the coming years.

There are caveats to this view. The steady productivity decline may reverse course with the advent of artificial intelligence. Many research organisations are predicting an annual AI productivity boost of 1% or more over coming years, which would lift economic growth potential and the equilibrium interest rate. Consumers in the US and across Europe spent the decade following the 2008/09 Global Financial Crisis (GFC) deleveraging their balance sheets, creating space for a new credit boom. A new credit boom would also lift economic growth potential and the equilibrium interest rate. The energy transition will come with higher energy costs which would depress economic growth potential, but the need for bigger government budgets would provide a counterbalance.

A compressed equilibrium interest rate bodes well for lower interest rates in 2024 and 2025 and for financial markets. The proviso is that we avoid a painful recession. The pessimists warn that rising interest rates take anywhere between 12-24 months to work through the economy and since the Fed started raising interest rates 16 months ago, much of the impact is yet to be felt. However, others cite the greatly improved household, company and bank balance sheets due to the decade of post GFC deleveraging and accumulated excess savings from Covid-era handouts, which make the private sector impervious to increased interest rates.

The latest Wall Street Journal economists' survey conducted from 7-12th July suggests the US economy will avoid a hard economic landing. The average forecast is for US GDP to have grown at a 1.5% annual rate in the second quarter (Q2) up from the 0.2% forecast in the previous survey. For Q3 they expect 0.6% growth compared to the 0.3% contraction projected in the previous survey. They only expect a mild 0.1% contraction in Q4 and for 2024 they forecast 1% growth, double the previous forecast of 0.5%. It seems a US recession, if it occurs at all will be mild and short-lived, the proverbial soft landing, which combined with disinflation and falling interest rates would be extremely positive for equity markets.

Local Report

Werner Erasmus

The Impact of Inflation on Investments: Strategies for Preserving Wealth

Inflation is a silent financial force that can significantly affect our investments and overall financial well-being. As prices of goods and services rise over time, the purchasing power of our money diminishes. This erosion of value has a profound impact on various investment avenues, making it crucial for investors to understand and plan for inflation's effects. Inflation has risen significantly in South Africa and globally since the Covid 19 pandemic on the back of constrained supply chains, government stimulus packages, low interest rates, rising oil prices and labour shortages. The trajectory of South Africa's headline inflation rate has been shaped primarily by fuel, electricity, and food price inflation. Inflation in South Africa peaked in July 2022 at 7.8% well above the 4.5% target

of the South African Reserve Bank (SARB). The above target inflation rates have resulted in the increase in interest rates in an effort by the SARB to bring inflation back down. Fortunately, inflation has been decreasing gradually since the peak in July 2022 with the latest figure for June 2023 CPI coming in at 5.4%. In this article, we explore the impact of inflation on investments and discuss strategies to preserve wealth in an inflationary environment.

1. Erosion of Purchasing Power: One of the most direct impacts of inflation on investments is the erosion of purchasing power. As inflation increases, the same amount of money will buy fewer goods and services. This means that even if your investment portfolio grows in nominal terms, its real value might decline when adjusted for inflation. For example, if your investments yield a 5% return, but inflation stands at 3%, your real return is only 2%.

2. Fixed-Income Investments: Fixed-income investments, such as bonds, are particularly vulnerable to inflation's impact. When you invest in a fixed-income security, you are essentially lending money to an issuer in return for periodic interest payments. However, if inflation rises during the investment's term, the purchasing power of those interest payments decreases. Additionally, when the investment matures, you might find that the principal amount can buy fewer goods and services than when you initially invested.

3. Equity: While equity is generally considered a hedge against inflation, its performance during inflationary periods can still be affected. Inflation can lead to higher production costs, reducing profit margins for companies. Moreover, companies may struggle to pass on these increased costs to consumers if their products or services face price sensitivity. As a result, a high and sustained inflation rate can negatively impact corporate earnings and, consequently, stock prices.

4. Property: Property is often considered a reliable hedge against inflation. During inflationary periods, the value of properties tends to rise, preserving the investment's purchasing power. Additionally, property can provide a source of passive income through rent payments, which may also increase with inflation. However, it is essential to note that real estate's performance can vary based on local market conditions and other economic factors.

Four Strategies to Preserve Wealth:

(a) Diversification: Diversifying your investment portfolio across different asset classes can help mitigate the impact of inflation. While some assets may suffer during inflationary periods, others may perform well, reducing overall risk.

(b) Inflation-Indexed Securities: Consider investing in inflation-indexed securities, like Treasury Inflation-Protected Securities (TIPS). These investments adjust their principal value based on changes in the Consumer Price Index (CPI), ensuring that your investment keeps pace with inflation.

(c) Equity Investments: Despite potential challenges, equities have historically outperformed inflation over the long term. Companies that can adapt to inflationary pressures are likely to maintain or increase their value over time.

(d) Property: Property, especially physical property, can function as a valuable hedge against inflation due to its tangible nature, appreciation potential, ability to generate rental income, and its relative low correlation to traditional assets. In addition to property, consider investing in tangible assets like precious metals, commodities, or infrastructure projects. These assets tend to retain value during inflationary periods.

Conclusion: Inflation is an erosive factor that negatively impacts the value of investments. Its eroding effect on purchasing power underscores the need for investors to plan and strategize accordingly. Diversification, inflation-indexed securities, equity investments, and real assets are all valuable tools for preserving wealth in an inflationary environment. By understanding inflation's impact and implementing prudent investment strategies, investors can navigate inflationary periods and achieve long-term financial success. Remember, staying informed and seeking professional advice can make a substantial difference in safeguarding your investments against the ravages of inflation.

Disclaimer

Information and opinions presented in this Market Report were obtained or derived from public sources that Overberg Asset Management believes are reliable but makes no representations as to their accuracy or completeness. Any opinions, forecasts or estimates herein constitute a judgement as at the date of this Market Report and should not be relied upon. There can be no assurance that future results or events will be consistent with any such opinions, forecasts, or estimates. Furthermore, Overberg Asset Management accepts no responsibility or liability for any loss arising from the use of or reliance placed upon the material presented in this Market Report.