WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 12 September 2023

Global Report

Nick Downing

Taking Profit on Japan

Global equity markets are on a knife-edge as we get closer to either recessionary conditions or a harmful breakout in bond yields. There are four possible outcomes for markets over the next 6-12 months. (1) Continued growth and high inflation. (2) Recession and high inflation (stagflation). (3) Recession and low inflation (most likely). (4) Continued growth and low inflation. The fourth outcome is the "goldilocks" so-called soft-landing scenario and is being increasingly discounted by global markets. A soft landing is difficult to achieve at the best of times but the likelihood of central banks engineering a soft landing after the fastest eruption in inflation and most abrupt interest rate hikes in over 40 years, seems remote. The lag time between monetary tightening and economic slowdown has been slowed down in this cycle due to the massive pandemic fiscal stimulus. In all likelihood a recession awaits. Although it should be shallow and mild given the lack of structural imbalances in the major economies, a recession will nonetheless prompt equity markets to pause.

After a brief hiatus, we expect global equities to show strong gains in 2024 and 2025, once central banks start cutting interest rates and bond yields begin to fall. In the meantime, we are taking the opportunity provided by strong markets to raise precautionary cash in portfolios. Selecting which share to sell is a hard decision as all holdings in OAM's global portfolios are appealing, with solid upside potential. Japan offers the best candidate for raising cash and it is a good feeling to sell after a strong run rather than from a position of weakness. Japan's Nikkei 225 is one of the best performing markets this year with an impressive year-to-date return of 27.45%.

Some analysts believe Japan is on the cusp of a new dawn, having beaten its decades long battle with deflation and with promises of improved corporate governance benefitting shareholder returns. There is also evidence to the contrary. Other analysts question Japan's new dawn narrative. Yes, inflation is back, and companies once again have pricing power but how long will it last? In 2014 after government raised the sales tax, company revenues boomed for a brief period but then fizzled out after a couple of years and deflation returned. Current inflation is supply-side rather than demand driven and likely to be transitory as wages are not keeping up with inflation. For inflation to become self-sustaining, wages need to rise in real terms, but wage growth continues to fall short of inflation so real wages are in fact dropping.

Real household incomes are dropping in Japan faster than any other developed economy, which is showing up in the GDP figures. Japan's GDP increased in the second quarter by an impressive 1.2% quarter-on-quarter at an annualised rate of 4.8% much faster than US growth of 2.4% over the same period, but the numbers belie a lack of momentum in household spending. Growth was driven by exports, in particular the post Covid catch-up in vehicle exports. Overall exports grew by 3.2%

quarter-on-quarter, but imports fell 4.3% indicating weak consumer demand, no surprise with real wages falling for a 15th consecutive month. Private consumption, which contributes 50% of GDP fell by 0.6% on the quarter and business spending fell by 1%. The contraction in real wages worsened to 2.5% year-on-year in July.

Corporate governance has been improving in recent years but there is little to show for it in terms of financial ratios. There is scant evidence of rising profit margins or higher return on equity. New corporate governance codes allow a lot of leeway. Only a fifth of companies are fully compliant with corporate governance codes while the remainder have been permitted to opt out. According to independent research firm Capital Economics, "the improvement in corporate profitability that happened during the early years of Abenomics has run out of steam since the start of the pandemic. Profit margins of Japanese listed non-financial firms are the second lowest in the G7."

Demographics present long-term structural impediments. The population continues to age, Japan's fertility rate fell in 2022 to a record low of 1.26 and unlike most other mature economies there is little sign of migration to boost its working age population.

The robust year-to-date gains in the Nikkei index are attributed singularly to weakness in the yen. There is a tight correlation between the currency's strength and the Nikkei index. Since the start of the year, the yen has weakened by over 12% against the US dollar, itself a weak currency this year. Yen weakness stems from the Bank of Japan's monetary policy uniquely sticking to negative interest rates. The BOJ's benchmark interest rate is pinned at -0.1% in sharp contrast with the US fed funds rate at 5.25-5.50%. The widening yield differential has caused the yen to weaken sharply against all major currencies, making exports more competitive and boosting export earnings, but the BOJ under its new governor Kazuo Ueda has begun to normalise Japan's ultra-accommodative monetary policy, starting with the gradual abandonment of its "Yield Curve Control." By lifting the cap on 10-year Japanese Government Bond yields, yields will rise making domestic bonds more appealing. Domestic institutions will be tempted to sell their foreign bond holdings and repatriate funds, to participate in improving domestic bond yields. The yen is expected to strengthen from its deeply undervalued levels as bond yields rise in Japan while bond yields decline in other markets led by expected interest rate cuts from the Federal Reserve.

We are reducing exposure to Japanese exposure across OAM's global portfolios by exiting Baillie Gifford Japan Trust Plc, a long-time stalwart of our clients' portfolios. The timing of the sale coincides with an unusually strong performance from the Nikkei index, which may be cut short by the yen's expected appreciation. Moreover, Baillie Gifford Japan invests principally in small- to medium-sized Japanese companies, which tend to be the most resistant to change in corporate governance. The cash raised from the sale will be reallocated when the opportunity arises to US markets, which we feel offer better prospects.

Local Report

Gielie Fourie

GDP Figures: 2nd Quarter 2023

GDP INCHED HIGHER AGAIN IN THE SECOND QUARTER OF 2023 (Q2 2023): The consensus forecast of economists for a contraction in economic growth in Q2 2023 was too pessimistic. They were wrong. Continuing on the trend set in the first quarter the economy inched higher again in the second quarter. South Africa's real gross domestic product (GDP) expanded by 0.6% in the second quarter (April–June) of 2023. This follows a 0.4% rise in the first quarter. Year-on Year (YoY) growth for the quarter was reported at 1.6%. The ongoing recovery in GDP is a relief.

The demand for machinery and equipment contributed to a 3.3% rise in imports. Imported products included those related to renewable energy, batteries, vegetable products, artificial resins and plastics, base metals and articles of base metals, and animal and vegetable fats and oils. South African exports edged higher by 0.9%, driven by increased trade in chemical products; prepared foodstuffs, beverages, and tobacco; vehicles and transport equipment; mineral products and machinery and electrical equipment.

WINNERS AND LOSERS: Six industries grew in the second quarter while four industries contracted. The best performing industry was agriculture, up 4.2%. Not all industries had a good second quarter. After 18 months of consistent growth, the transport, storage, and communication industry stumbled, declining by 1.9% - the worst performing industry in the second quarter.

GDP is calculated from data gathered from ten industries. The ten industries are subdivided into three sectors. The three-sector model consists of the Primary Sector, the Secondary Sector, and the Tertiary Sector. To remove the effect of inflation, GDP is measured at constant 2015 prices. Quarterly figures are seasonally adjusted.

THE PRIMARY SECTOR: This sector represents companies that are engaged in extracting natural resources. There are only two industries in this sector namely agriculture, and mining. (1) Agriculture, forestry, and fishing - QoQ growth increased by 4.2%. After two consecutive quarters of decline, South African agriculture turned positive. The 4.2% rise in output was driven by increases in the production of field crops and horticulture products. Favourable weather conditions, increased cultivation and a rise in export demand provided further support. (2) Mining - QoQ growth increased by 1.3%. Mining looked good too, posting a second straight quarter of growth. Platinum group metals, gold, and coal helped lift the industry.

THE SECONDARY SECTOR: This sector covers all those activities involved with the processing of raw materials, like the manufacturing and construction industries. Three industries are active in this sector. (3) Manufacturing - QoQ growth increased by 2.2%, attributed mainly to petroleum, chemical products, rubber, and plastic products. Manufacturers in metals, metal products, machinery and equipment also recorded a good quarter, driven in part by increased demand for crude steel. (4) Utilities - QoQ growth decreased by 0.8%. The electricity, gas and water industry decreased in the second quarter, largely due to decreases in electricity production and consumption. (5) Construction - QoQ growth decreased by 0.4%. After holding its head above water for nine months, the construction industry lost steam in the second quarter. A decline in economic activity related to non-residential and residential buildings pulled the industry lower. There was a small uptick in construction works, but this was not enough to lift the industry into positive territory. This is a pity because construction is vital for economic growth. The militant construction mafia has brought many construction businesses to their knees, a key reason why this industry is struggling and remains the smallest in South Africa.

THE TERTIARY SECTOR: This sector comprises the provision of services rather than end products. (6) Trade, catering, and accommodation - QoQ growth decreased by 0.4%. The trade industry was down on the back of weaker retail and wholesale figures. The overall decline was partially offset by increased activities in the tourist accommodation and restaurant, catering, and fast-food sectors. Hotels are doing well. Both City Lodge and Sun International reported good figures and are bullish for the remainder of the year. (7) Transport and communication - QoQ growth decreased by 1.9%. The industry was lacklustre and there were declines in land freight and road passenger transport. (8) Finance and business services - QoQ growth increased by 0.7%. It is the largest industry in the economy. The finance industry edged higher, boosted by financial intermediation, insurance, and real estate services. (9) Personal services - QoQ growth increased by 0.7%. The personal services industry was positive on the back of higher growth in education and health. (10) Government services - QoQ growth increased by 0.6%. The rise in general government services was mainly due to an increase in staff numbers.

THE INTERNATIONAL MONETARY FUND (IMF): The IMF's recommendations to fast-track growth are to reduce the regulatory burdens and other entry barriers to foster competitive product markets and promote private investment, especially for job-creating SMEs. The IMF also recommends forcefully tackling state capture and inefficient state-owned enterprises (SOEs) as they represent a heavy burden on the budget, and finally, to restore energy security. This will require attracting private sector participation in the electricity market and addressing Eskom's operational and financial deficiencies.

BOTTOM LINE: Last quarter we reported on the IMF's March 2023 findings that South Africa's economic and social challenges are mounting and that the near-term growth outlook for SA has deteriorated. It painted a bleak picture. The Q2 2023 growth figure showed the IMF was too negative. In the long-term, the South Africa GDP Growth Rate is projected by Stats SA to trend around 1.20% in 2024 and 1.60% in 2025. The upturn in 2024 assumes that the SARB will initiate its rate cutting cycle.

Source: Stats SA, IMF.

GDP Growth at constant 2015 prices and seasonally adjusted

Quarterly	Q3 2022	Q4 2022	Q1 2023	Q2 2023
GDP Growth QoQ	1.80%	-1.10%	0.40%	0.60%
Annually	2019	2020	2021	2022
GDP Growth YoY	0.30%	-6.00%	4.70%	1.90%

Source: Stats SA.