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WEEKLY REPORT

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Global Report

Nick Downing

Peak interest rates in sight

Apart from the Bank of Japan, the other major central banks representing the G7 group of nations have implemented the most dramatic cycle of interest rate increases since 1979. The Federal Reserve has lifted its benchmark fed funds rate from 0.0-0.25% in March 2022 to 5.25-5.50%. The European Central Bank has raised its benchmark interest rate from minus 0.5% in July 2022 to 4.0%. The Bank of England started earlier than the other two in December 2021, lifting its base rate from 0.1% to 5.25%.

Over the past fortnight, the three major central banks have paused their rate hiking cycles, providing positive impetus to financial markets. The S&P 500 index, boosted also by employment data that suggests inflation may be under control, enjoyed its best week in 12 months with a 5-day gain of 5.9%. The 10-year US Treasury bond also celebrated with a substantial decline in yield over the week from 4.92% to 4.56%. When yields drop, bond prices rise.

There were subtle signals that the central banks had reached peak interest rates. Federal Reserve Chair Jerome Powell highlighted how much inflation had fallen rather than emphasising the resilience of the economy. He said that the central bank could proceed “carefully” with future decisions, in sharp contrast to previous policy meetings when he unequivocally telegraphed further rate hikes to come. ECB president Christine Lagarde said keeping rates at their current level would make “a substantial contribution” to achieving the 2% inflation target. BOE Governor Andrew Bailey said that “higher interest rates are working, and inflation is falling.”

The economic data supports a pause in interest rates. The Eurozone economy is teetering on the edge of recession and inflation is dropping sharply. GDP fell in the third quarter (Q3) by 0.4% quarter-on-quarter annualised and its consumer price inflation (CPI) fell in October to 2.9% year-on-year down from 4.3% in September. In the UK, CPI remains elevated at 6.7% according to the September reading but the economy is flatlining, and the BOE expects inflation to fall in October and over coming months. It forecasts UK GDP will grow in Q4 by just 0.1% and show nil growth in 2024. By contrast, US recorded 4.9% annualised GDP growth in Q3, accelerating from its 2.1% pace in Q2. However, growth is forecast to slow to 1.2% in Q4 and by more in 2024 as the lagged impact of interest rate increases takes effect.

Inflation in the US is steadily declining. Core CPI, excluding energy and food prices, has dropped from a high of 5.6% in 2022 to a 3-month annualised rate of 2.8%. Wage growth has slowed from a high of 6% to 4.1%. A 4% wage growth rate, less the current rate of labour productivity growth of just above 2%, is consistent with a 2% core CPI rate. Excluding shelter prices, core CPI is already at 2%. If shelter inflation turns negative over the next 12 months as predicted by the San Francisco Fed, core CPI will

drop well below the 2% target by next year. Shelter prices have a 40% weighting in the US core CPI basket.

Despite the evidence, central banks are treading cautiously. Having fought hard to make financial conditions restrictive, they do not want economic activity to reaccelerate until inflation is truly vanquished. Having made the mistake in 2021 of calling the inflation spike “transitory”, central banks are anxious to avoid making the same mistake a second time. Hence, they are sticking to their “hawkish” rhetoric. Central banks insisted that interest rates would remain “higher for longer” with no indication of any rate cuts on the horizon. Lagarde said “rates will be set at sufficiently restrictive levels for as long as necessary,” Bailey said “we need to see inflation continuing to fall. It is much too early to be thinking about rate cuts,” and Powell said, “the committee is not thinking about rate cuts at all.”

Brave investors are itching to get stuck back into the equity and bond markets. Bonds are once again providing attractive real yields and equities, prior to last week’s rally, had pulled back by around 10% from July’s levels, therefore showing greater value. Studies show that investors who buy at the peak, in the week of the last interest rate hike, are richly rewarded. Those who buy months before the peak do less well and those who wait until the first rate cut also do less well, since by then the potential excess gains will already be discounted.

In hindsight it will be obvious when policy rates hit their peak but until rates start falling, the debate will continue. Just today, the Reserve Bank of Australia ended a four month pause in its rate hiking cycle, lifting the Official Cash Rate by a further 25 basis points from 4.1% to 4.35%. The Bank of Canada has warned that it is ready to hike rates again saying that it is “concerned that progress towards price stability is slow and inflationary risks have increased.”

There is a risk that the Federal Reserve may pause for a while, only to resume its hiking cycle. The more likely scenario, however, is that rates at the Fed, ECB and BOE will remain unchanged at current elevated levels for a prolonged period before eventually declining, with central banks following the “higher for longer” mantra. There should be no need to hike further given that inflation is already on a downward path without the full impact of rate tightening being felt. Moreover, as inflation continues to fall, the “real” interest rate (the nominal policy rate minus the inflation rate) will increase of its own accord. Just by keeping policy rates unchanged the central banks would effectively be tightening monetary policy. Despite the hawkish rhetoric, the odds are that peak rates are already behind us.

Local Report

Francois Louw

The intricate balancing act: A look at the 2023 MTBPS and beyond.

South Africa has been struggling to achieve sustained economic growth for some time now, and that was the underlying theme of the 2023 Mid-Term Budget Policy Statement (MTBPS) presented by Enoch Godongwana, Minister of Finance, on 1 November 2023. Stagnant real gross domestic product (GDP) growth is expected to continue, falling from 1.9% in 2022 (supported by the post-COVID recovery) to just 0.8% this year. Future projections indicate a 1% growth rate for 2024 and 1.6% for 2025. Factors

that have been contributing to our sluggish economic growth include the electricity supply problem, the efficiency of the railroads and port system, and failure to attract infrastructure investment, to name a few.

In this balancing act of inflows and outflows, we delve into more detail to see exactly where the country came up short in terms of revenue. Government tax collections for the current fiscal year are R57 billion below what had been forecasted just six months ago in the National Budget Speech, and projections for 2024 indicate it to be around the R54 billion mark. It is also estimated that there could be a revenue shortfall of around R68 billion in 2025, the final year of the 2023 MTBPS. To counteract this shortfall, Minister Godongwana stated that after the National Budget Speech in February 2024, measures will be put in place to raise an additional R15 billion in taxes in 2024/'25 from the already overburdened taxpayers of South Africa.

The main contributor to the revenue imbalance was tax collections in the corporate sector. Tax collections from companies were down R35.8 billion, or 10.7% from the value of R336 billion budgeted in February this year (Table 3.1 below). The lower revenue performance was driven by a sharp fall in corporate income tax, particularly from the mining sector, although personal income tax collection was better than forecasted. Corporate tax collections from the mining industry fell by R24.6 billion or 55.4% relative to the same period in 2022-'23. These collections were heavily impacted by lower commodity prices, stagnant global economic growth, load shedding, and logistics constraints. Another factor that also widened the gap between budgeted and actual revenue was an increase in value-added tax (VAT) refunds of R22 billion compared to the same period last year.

Table 3.1 Gross tax revenue

R billion	2022/23			2023/24		
	Budget[1]	Outcome	Deviation	Budget[1]	Revised	Deviation
Persons and individuals	601.6	600.4	-1.3	640.3	646.7	6.4
Companies	344.9	344.7	-0.3	336.1	300.3	-35.8
Value-added tax	426.3	422.4	-3.9	471.5	445.8	-25.6
Dividends tax	38.5	38.1	-0.4	39.8	36.2	-3.6
Specific excise duties	55.2	55.2	-0.1	59.0	55.3	-3.7
Fuel levy	79.1	80.5	1.3	90.4	92.0	1.6
Customs duties	74.2	73.9	-0.2	74.2	77.7	3.5
Ad valorem excise duties	4.5	5.5	1.1	4.7	6.6	1.9
Other	67.8	66.0	-1.7	71.5	69.9	-1.5
Gross tax revenue	**1 692.2**	**1 686.7**	**-5.5**	**1 787.5**	**1 730.7**	**-56.8**

1. 2023 Budget
Source: National Treasury

In 2023, it is estimated that Transnet (the logistics monopoly) misallocated an estimated sum of R411 billion because of rail inefficiencies stemming from issues such as cable theft, operational shortcomings, and inadequate infrastructure conditions. Had Transnet managed to avoid this loss, we could have seen a different account balance. Godongwana stated that Transnet will not receive its requested bailout of R100 billion at this time without adhering to several specific conditions.

The other side of the scale is the expenses incurred. At the forefront of expenses in the budget is government debt, and the interest payable for access to that capital. Total gross debt currently sits at R5.2 trillion and will exceed R6 trillion by 2025. Going forward, Minister Godongwana stated that

it will be necessary to borrow R553 billion annually over the medium term to fund operations. In 2023, an astonishing R386 billion will be allocated for interest payments on outstanding debt. This expense of government debt servicing currently constitutes a larger proportion of the budget than allocations for basic education, social protection, or healthcare.

As per Godongwana's statement, the objective is to achieve debt stabilization by fiscal year 2025-'26. However, it is worth noting that the initially projected debt-to-GDP ratio of 73.6% for 2025-'26, as outlined in the February budget, now necessitates revision to an elevated figure of 77.7%. The escalation in expenditure can be attributed to two principal factors: firstly, the rise of the public sector wage bill, which facilitated a 7.5% increase in wages for the year 2023; and secondly, the allocation of resources to sustain the Social Relief of Distress (SRD) grant, amounting to R34 billion. Minister Godongwana extended the SRD grant program until March 2025.

The number of government employees now earning more than R1 million per annum, grew from 10,000 in 2013/2014 to over 55,000 today (that is an increase of 450%). Dion George, finance spokesperson for the DA, made an urging statement to the ANC, to impose a three-year wage freeze for public servants, and more specifically head office managers and supervisors (excluding teachers, nurses, and other professionals). He also believes that South Africa has too many managers and supervisors in the public sector and that we do not have the available funds to sustain even an inflation-linked increase in wages going into next year. According to his estimates, this three-year wage freeze together with the laying-off or demotion of unneeded managers and supervisors, could save the economy up to R126 billion over the next three years. South Africa's public sector wage bill is one of the highest among emerging market countries.

What does this mean for investors? The MTBPS had a short-term positive impact on local financial markets, but our eyes now turn to next year's National Budget Speech in February. Economic growth prospects remain weak, and South Africa is still experiencing electricity generation issues at Eskom together with the overall mismanagement of the other SOEs. There were some positive takeaways, but our local investment strategy remains unchanged.

Bottom Line: Godongwana's announcement of budget cuts is a positive sign, with spending reductions of R21 billion for 2024 and substantial cuts in the following years. Additionally, the promise of restructuring state departments offers hope, albeit with uncertain details. However, the MTBPS may be overly optimistic. Notably, it omits two significant expenses: the R254 billion Eskom bailout approved in February and the R100 billion Transnet bailout request. The inclusion of these bailouts would reveal a much larger deficit.

It is a difficult time to interpret the MTBPS, with the 2024 general elections just around the corner. The ANC's challenge lies in reconciling its past with the imperative of fiscal responsibility to pave the way for a more secure and prosperous future while at the same time looking after its shrinking support base. This intricate balancing act will define the party's ability to lead in a complex and demanding political landscape.

Sources: Biznews, Moneyweb, Daily Maverick, National Treasury, Standard Bank.

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