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WEEKLY REPORT

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Global Report

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Global Market Prospects

2023 proved to be a rollercoaster year for global financial markets. The year began with an almost unanimous view that the US and global economy would enter recession and that central banks would be obliged to cut interest rates. Instead, the world's economy continued to expand, and central banks kept interest rates "higher for longer". Equity markets showed decent returns, although these were led by outsized gains in the so-called "Magnificent Seven" (M7) large-cap US technology stocks (Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla, and Meta), which accounted for 80% of the gains in the US S&P 500 index. Massive sector rotation over 2022 and 2023 frustrated most investors in balanced portfolios. In 2022, only the energy sector delivered positive gains, while technology suffered a substantial drawdown. The drawdown was made up in 2023, but only enough to recover the previous year's losses. On an aggregate level, equity markets have yet to make any progress beyond their end-2021 levels. Meanwhile sovereign bonds suffered their worst two-year performance in 150 years, with the S&P G7 Sovereign Bond index sliding 16.5% over the period.

The fourth quarter (Q4) started badly due to the continued surge in bond yields amid indications the Federal Reserve and other central banks would continue hiking interest rates. At one point in mid-October the US 10-year Treasury bond yield exceeded 5.0%, a tremendous increase from 3.88% at the start of the year. The yield is the benchmark for the global cost of capital and the basis for valuing all financial assets. Rising bond yields increase the market's required rate of return from equities, putting pressure on share prices. Rising Treasury bond yields also sap global liquidity. Global liquidity is crucial to keeping financial assets buoyant.

Confidence was restored in November by lower-than-expected inflation data which led to lower bond yields and implied a peak in central bank interest rates. The Fed, ECB and BOE have not lifted their benchmark interest rates since July, September, and August, respectively. At its December policy meeting the Fed signalled that interest rate cuts would come, amounting to 75 basis points in 2024 and a further 100 basis points in 2025. Despite falling inflation and high interest rates, economies continued to sidestep recession, raising hopes of an eventual soft landing in the US and only mild cyclical recessions in the UK and Eurozone. US GDP grew at an annualised rate of 4.9% in Q3, matching China's growth rate over the same period. The UK recorded 0.0% growth in Q3 and the Eurozone not much better at 0.1%, but both avoided recessions. Japan's GDP shrank 2.1% in Q3 giving back some of its strong growth of 3.7% in Q1 and 4.5% in Q2 but is expected to resume its growth trend in Q4. Economies were helped by lower energy prices, both in taming inflation and stimulating growth. Fortunately, the Middle East conflict remained confined to Gaza, causing the Brent oil price to fall from $95.3 per barrel at the end of Q3 to $77.1 by year-end.

In Q4, the US 10-year Treasury bond yield fell sharply from 4.57% to 3.87%. The S&P G7 Sovereign Bond index rallied by 7.4% in Q4 putting the index in positive territory for the year by 2.4%. Japan's Nikkei 225 index was the best performing market for the year, rising by 28.2%, helped by substantial yen depreciation. The S&P 500 index gained 24.2% but excluding the M7 shares, its increase would have been under 6%. The German Dax gained over the year by 20.3% although the UK FTSE 100 only gained by 3.8%, hindered by a strengthening pound and the relative absence of technology shares in the index. The pound appreciated versus the dollar by 6.3% over the year. China's CSI 300 index trailed with a loss of 11.4% due to disappointment over the scale of economic stimulus and continued correction in the residential property market. China's performance undermined the MSCI Emerging Market index, which only gained 3.6% compared with the MSCI All Country World index, which returned a substantially higher 17.7%. To illustrate the impact of the M7 shares, that collectively have an 18% weighting in the MSCI All Country World index, the MSCI ACWI Equal Weighted index, which has an equal rather than weighted allocation to its constituents, only increased 2.3% over the year.

The 2024 outlook for equity markets and financial assets is encouraging. The strong market recovery that started in Q4 is expected to be maintained by further falls in inflation and the start of interest rate cuts, led initially by the Fed, and followed by the ECB and BOE. Inflation is the most important variable in the current market cycle. The faster inflation comes down, the greater the chances of an economic "soft landing". The inflation surge, which is more akin to the inflation shock which followed WW2 than the 1970s, is likely to come to an end in 2024, led by the US where shelter costs are due to come down sharply over coming months. The latest figures show shelter as the sole component keeping inflation elevated. On a 3-month and 12-month annualised basis, core US CPI excluding shelter is at 1.5% and 2.1% respectively. As the shelter component of CPI lags the sharp decline in the housing and rental markets, a significant inflation decline is in prospect. The sceptics believe tight labour markets will prevent inflation returning to central bank targets, but improved labour productivity is providing sufficient relief, especially in the US. In the US, labour productivity growth has risen to 2.4% from a dramatic low of -2.4% during the pandemic. This means the "inflation residuals" of wage growth, defined as wage growth minus productivity growth, have already fallen to 1.4%, in line with pre-pandemic levels. It is likely that Artificial Intelligence (AI) will entrench these productivity gains.

It is quite possible that only a small reduction in demand will be sufficient to tame inflation, which means central banks may not need to wait for a recession before cutting interest rates. Falling policy rates will allow bond yields to decline across advanced economies. Lower policy rates and lower bond yields will stimulate economic growth, ushering in a new economic and investment cycle. According to economists' forecasts, there is only a 50% chance that the US economy will enter recession. Although rare and achieved more by luck than careful planning, there is a strong chance the US will enjoy a "soft landing", in which the economy slows enough for unemployment to rise and inflation to decline but without tipping into recession. Europe and the UK are expected to enter recession in 2024 but in the absence of structural imbalances the recessions are likely to be mild and short-lived. China should achieve its targeted growth rate of 5%.

Equity markets could suffer mild losses from current levels if economic activity slows due to the lagged impact of monetary tightening, but markets are forward looking and will tend to look through the mild recessions towards falling interest rates and economic recovery. The US should maintain pole position based on its AI dominance and being first in the falling inflation and monetary easing queue. A bubble may well develop in AI-related stocks, which could continue into 2026. Parallels have even been drawn with the productivity boom of the 1920s, which followed WW1, the 1918

Spanish Flu pandemic and a brief recession in 1920/1921. This period was followed by booming business activity, and game changing new technologies and innovations such as electricity, the automobile, and the telephone. The 2020 Covid pandemic unleashed “Work from Home” and in the past year AI technology has accelerated, which has the potential to bring widespread economic benefits and increased labour productivity. Rising productivity will bolster economic growth while bringing down inflation.

There are always risks. The hoped for soft landing may elude the US and recessions elsewhere may be harsher than expected but risks are low given the extent of deleveraging since the 2008/09 Global Financial Crisis. Private sector balance sheets are in good shape. Alternatively, inflation may plateau above central bank targets, for instance if recent productivity gains are a once-off phenomenon, but this is unlikely given the transformative potential of AI. On balance, there is a good chance that inflation drops below central bank targets. So far, the inflation decline has been driven by non-cyclical supply-driven effects. Once cyclical demand-driven effects gather pace in response to the lagged impact of monetary tightening, the inflation decline may well accelerate. While continuously mindful of the risks, we are confident that the next two years will provide solid returns in equity markets as well as bond markets. Bond markets, for the first time in many years, are now offering attractive yields.

Local Report

Nick Downing

Local Market Prospects

South African financial markets were broadly positive in the fourth quarter (Q4) despite little noticeable improvement in the domestic economic outlook, although sentiment must have been boosted when the Springboks returned home with the Webb Ellis Cup. The JSE took its cue from global markets, which benefitted from stronger than expected economic growth and helpful inflation data, opening the prospect of central bank interest rate cuts in 2024 and the increased likelihood of a soft landing in the US. The Industrial 25 index, assisted by its heavy weighting in rand hedge shares and weakness in the rand, gained 5.5% in Q4, lifting its return for the full year to 14.8%. The Financial 15 index continued to benefit from elevated Reserve Bank interest rates, gaining a sizeable 10.3% in the final quarter and 15.1% over the year. Weaker commodity prices and rising costs associated with electricity outages, freight and railway delays undermined the Resources 10 index, which failed to participate in the Q4 market rally, ending unchanged over the quarter and down 18.7% for the year. The JSE All Share index enjoyed a strong finish to the year, up by 6.2% in the quarter, but returning a relatively subdued 5.3% in 2023, due to weakness in the resource sector. The rand gained by 3.3% against the US dollar in Q4 but still lost 7.5% over the full year, depreciating from R/$17.02 to R/$18.30. The RSA 10-year Government Bond yield fell sharply over the quarter in line with falling global bond yields, from 10.81% to 9.76%, and below its end 2022 level of 10.18%. Gold regained its lustre as financial markets began to discount lower interest rates. The dollar price per ounce increased 11% in Q4, rising from $1861 to $2065, ahead of the end 2022 level of $1866.

The latest Q3 economic growth numbers were disappointing. GDP shrank by 0.2% quarter-on-quarter while Q2 growth was revised lower from 0.6% to 0.5%. On a year-on-year basis, GDP shrank in Q3 by 0.7%. Infrastructure constraints at Eskom and Transnet were the chief culprits, with energy, railway and port disruptions undermining production. Jason Turvey emerging markets economist at independent research firm Capital Economics summarised the economic malaise: "The big picture is that South Africa's recovery from the pandemic has been among the worst in the emerging world, with GDP just 0.3% above its pre-pandemic peak." Over the quarter, the primary and secondary sectors were the worst affected, including agriculture, mining, and manufacturing, which suffered quarter-on-quarter declines of 9.6%, 1.1% and 1.3%, respectively. Construction declined 2.8%, brought to its knees by the increasingly militant construction mafia. The tertiary sector, which is less dependent on the country's infrastructure, managed modest growth in some industries including transport and communication, finance and business services, government services, and personal services.

If the economy shrinks for a second consecutive quarter, the country will technically have entered recession. Low employment growth and weak real wage growth along with high consumer borrowing costs will keep consumer confidence and household spending subdued. Infrastructure constraints and government policy uncertainty, especially ahead of the General Election later this year, will keep business confidence restrained. The quarterly RMB/BER consumer and business confidence indices eased in Q4 from already depressed levels, from -16 to -17 and from 33 to 31, respectively, although surprisingly the South African Chamber of Commerce and Industry (SACCI) monthly business confidence index increased in November to its highest since February. Forward looking activity surveys painted a mixed picture. The economy-wide S&P Global Purchasing Managers' index (PMI) remained below the neutral 50-level, falling in December from 50 to 49, although the Absa manufacturing PMI unexpectedly increased over the same month from 48.2 to 50.9.

The South African Reserve Bank (SARB) kept its benchmark repo interest rate fixed at 8.25% at its last policy meeting of the year on 23rd November, unchanged since May when it was raised by 50 basis points. However, SARB Governor Lesetja Kganyago gave little indication that interest rate cuts were forthcoming, assessing that: "While our baseline inflation forecast has improved, risks to the inflation outlook are still assessed to the upside." The SARB reduced its headline and core CPI forecasts for 2024 from 5.1% to 5.0% and from 4.7% to 4.6%, respectively, within its 3-6% inflation target but still above the 4.5% midpoint. The latest inflation figures for November suggest rand weakness, and persistent energy and food inflation are keeping price pressures elevated. Headline CPI was 5.5% year-on-year compared with 4.7% in July, while core CPI, which excludes food and energy prices, was 4.5% up from 4.4% in October. The SARB will likely err on the side of caution, providing monetary policy stimulus only after the world's major central banks have taken the lead in cutting interest rates.

The SARB raised its GDP forecast for 2023 slightly higher from 0.7% to 0.8%, at the same time lifting its forecasts for 2024 and 2025 to 1.2% and 1.3%, respectively, in large part due to an expected decrease in load shedding. According to its accompanying policy statement, "Energy and logistical constraints are still binding on economic activity and generally increase costs. We expect electricity supply to increase gradually over the medium-term however, helping to raise our forecast for output growth in 2024, 2025 and 2026." Businesses and households are rapidly increasing their contribution to the grid via renewable energy supply, with rooftop solar panels already comprising 10% of the country's energy capacity.

The country's sluggish growth is partly due to cyclical effects such as weakening export markets and high interest rates, but business leaders are increasingly laying the blame on President Ramaphosa's government, notably its lack of badly needed structural reforms, weak governance, and ingrained corruption. State capacity is collapsing. While the severity of the electricity crisis shows signs of moderating, the burgeoning water crisis and Transnet's logistics crisis are both rapidly becoming as large as the Eskom debacle. Organised crime is rising at an alarming rate. South Africa has been ranked seventh in the world this year in the GI-TOC Criminality index, from 19th in 2022. The NPA has yet to achieve a single state capture conviction. The likelihood of South Africa being removed from the Grey List at FATF's next review seems remote at this stage. 2024 is the election year, bringing the country's politics into sharp focus. Greater energy and coordination from the opposition, with the Multi-Party Charter signed in August and new parties including Rise Mzansi and Change Starts Now, should encourage increased voter turnout, to the detriment of the ANC. The ANC is nonetheless expected to hang onto national power, probably via a small party coalition. However, opposition parties stand a realistic chance of winning provincial leadership in Gauteng and KZN, in addition to the Western Cape. This could provide momentous improvement for the country's key municipalities and metros, which have been suffering accelerating decay in recent years.

The litany of challenges facing the country is well documented and understood by investors. It is no surprise therefore that foreign investors were net sellers of South African listed shares in 2023 to the tune of R143.5 billion while South African pension funds have their maximum 45% allowance invested overseas. With the bad news mostly discounted, the JSE is cheap. The JSE All Share price-earnings multiple is 10.9x, showing a steady derating over the past three years, from 22.9x to 12.5x and 11.9x at the end of 2020, 2021 and 2022, respectively. The JSE currently trades at a 20% discount to the emerging markets benchmark compared with its historical average premium of 20%. At the same time, the rand is among the most undervalued emerging market currencies. While shares are cheap and the currency attractive, the country needs a catalyst to unlock this value. Reduced load shedding and political change at key metros may provide a lift to business, consumer, and investor sentiment, but other key state-owned enterprises are rapidly creating new headaches, and stresses on the fiscus, which means foreign investors may well continue to look elsewhere in the emerging market universe for the foreseeable future.

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