OVERBERG MARKET REPORT

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Global Report

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Global Market Prospects

Cyclical economic momentum picked up in the second quarter (Q2), as represented by the global manufacturing purchasing managers' index (PMI) which returned to expansionary territory for the first time in two years. Growth is broadening globally amid rising goods demand and trade volumes. GDP growth has accelerated in the more cyclical economies. Eurozone GDP grew in Q1 by 0.3% quarter-on-quarter compared with -0.1% in Q4 last year, helped by rising export demand. UK GDP grew by 0.7% in Q1 compared with -0.3% the previous quarter, while China's economy grew by 5.3% annualised compared with 5.0% in 2023. The US has exhibited signs of slowing, its GDP growth slowed in Q1 to 1.4% annualised from 3.4% the prior quarter, but economic data remains consistent with growth in the 1-2% range. This should be slow enough for inflation to return to target, while avoiding recession.

Global earnings have risen steadily over the past year and the gains in economic momentum have led to upgrades in consensus 12-month forward earnings forecasts. Equities are well supported by rising earnings and easing financial conditions. During the quarter, the European Central Bank, Swedish Riksbank and Bank of Canada each cut their policy interest rate by 0.25%. These rate cuts together with an earlier rate cut by the Swiss National Bank in Q1, mark the beginning of a new global monetary easing cycle which is expected to continue into 2025. The Bank of England and Federal Reserve are expected to initiate their rate cutting cycles in Q3.

Most equity markets gained further ground in Q2, helping the MSCI All Country World index notch up its third straight quarter of gains. The index increased 2.4% in Q2 and 10.3% year-to-date (YTD). Strong earnings growth powered US based technology shares, which pushed the technology heavy Nasdaq Composite index higher in Q2 by 8.3 and 18.1% YTD, benefitting the S&P 500 index, which gained by 3.9% and 14.5%, respectively. Other markets lagged the US although still fared well. The UK's FTSE 100 index gained 2.7% and 5.6% in Q2 and YTD, respectively, while the German Dax returned -1.4% and 8.9% over the periods. The Nikkei suffered a setback after its stellar performance in Q1 as its GDP unexpectedly shrank 2.9% annualised in the quarter, pulling the index down 1.9%, but YTD remains the best performing market with a return of 18.1%. Its economy will benefit from the improving trade cycle and the end of its decades' long battle with deflation. Japan's company profit margins are at a record high.

China's CSI 300 index was the laggard among major equity markets, despite solid earnings growth in the consumer discretionary and communication services sectors, which make up 50% of its market. The index fell 2.1% in Q2 resulting in a meagre 0.9% YTD return as global investors remained wary of the ongoing decline in its residential market. The MSCI Emerging Market index gained 4.1% in Q2 and 6.1% YTD despite China's weak performance, as other emerging markets benefited from improving growth conditions and compelling valuations. While equity markets were lifted by improving growth and rising earnings, government bonds fared less well due to nagging concerns over inflation which

caused yields to rise. As bond yields rise, prices drop. The US 10-year Treasury bond yield ended the quarter at 4.34% up from 4.21% at the end of Q1 and 3.87% at the end of December. The S&P Global Developed Sovereign Bond index (USD) lost 2.7% in Q2 resulting in a YTD loss of 7.1%.

The US exhibited the strongest earnings growth with S&P 500 earnings expanding at a solid pace for the second straight quarter in Q1. Earnings grew 8% and expected to grow by roughly 11% in Q2 according to consensus forecasts, while 12-month forward earnings have continued to climb leading to rising forecasts for 2024 and 2025. However, most of the earnings growth is concentrated in a small number of mega-cap technology shares. The so-called Magnificent 7 shares account for 33% of the S&P 500 market capitalisation and they continue to enjoy superior operating margins and sales growth compared with the rest of the market. However, the level of market concentration may decrease as Fed easing leads to a re-rating of cheaper areas of the market, such as small cap shares which tend to outperform in falling interest rate cycles.

Equity markets are poised to continue rising, if as appears likely, recessions are avoided and at the same time financial conditions ease. Inflation remains a nagging concern especially in the US, but even there it appears to have resumed its downtrend. Following disappointing inflation data earlier in the year, US CPI fell in May to a new cyclical low of 3.4% year-on-year. Shelter inflation, which continues to be the main component propping up core CPI, remained sticky at 5.4% but lags from market rents to shelter inflation signal a further deceleration in shelter inflation over coming months. Core CPI excluding shelter registered just 1.9%, below the Fed’s target. A softening labour market showing an increase in the unemployment rate to 4.0% in May, in line with the Fed’s year-end forecast, suggests a greatly reduced risk of a wage price spiral. The Fed’s 2024 year-end target for its core PCE inflation measure of 2.8% has also already been met, and the measure fell further from 2.8% to 2.6% in May paving the way for the start of interest rate cuts.

There is some concern that the AI-fuelled technology bubble will burst, bringing down financial markets. Although the valuations of AI-related sectors have risen to elevated levels, most of the rally has been backed by strong earnings growth, which shows no sign of slowing. Conditions are in place for the AI-boom to follow a similar trajectory to the dotcom boom of the 1990s. By comparison with the dotcom bubble and its duration, AI-related shares are cheap, and the rally is still in its relatively early phase with the potential to continue through to the end of 2025.

Geopolitics has the potential to sour investor sentiment, especially the US presidential election in November, which could be unusually divisive. However, markets usually ignore US political unrest and historically have gained even during tense election years. In 1968 for instance, US financial markets were unaffected by the massive political shocks that year, including the assassinations of Martin Luther King and Robert F. Kennedy, the Tet offensive in Vietnam and anti-war protests. The S&P 500 index went on to gain 8%. The wars in Ukraine and the Middle East have the potential to intensify, leading to a recessionary oil price spike, but the world has become steadily less dependent on fossil fuels, which would limit the impact, especially in the US which is energy independent and therefore unaffected by global energy supply disruptions.

The more likely risk for financial markets is to the upside, involving a productivity led disinflationary boom which could unfold this year and beyond. A synchronised global expansion driven by rising labour productivity may result from major AI-related investment spending, which could rival the internet revolution of the 1990s. The internet lifted US labour productivity by 1-1.3% per year from the second half of the 1990s to the first half of the 2000s, creating a disinflationary boom. Investment in AI technology could achieve similar productivity led growth over coming years. In the US, which has been the largest beneficiary so far, non-financial sector productivity is already rising at a

substantial 3.5% annual rate. Productivity gains have been a key factor behind the solid earnings recovery since 2023.

A disinflationary expansion bodes well for equities. While US earnings growth maintains the upper hand, led by AI-related sectors, the rest of the world is rebounding which should result in more regions and sectors participating in the equity bull market. Provided inflation continues to decline, the world's central banks, including the Fed, will stick to their monetary easing cycles, benefiting small-cap shares and other sectors which have been left behind and offer especially attractive valuations.

Local Report

Nick Downing

Local Market Prospects

South Africa's financial markets performed strongly in the second quarter (Q2), with the bulk of returns concentrated in June amid post-election relief and the formation of an ANC led Government of National Unity (GNU) with the DA, IFP and other smaller parties. Helped by a strengthening rand, the dollar-based MSCI South Africa index rallied 9.2% in June, outperforming the MSCI World index and MSCI Emerging Market index, which gained by 1.9% and 3.6%, respectively. The JSE All Share index gained 6.9% in Q2, reversing its Q1 loss and returning 3.7% year-to-date (YTD). The Financial 15 index was the highflyer in Q2 with a 14.4% return, gaining 5.6% YTD. The shares of banks and insurers amplified the improvement in risk appetite for domestically focused shares. The Resources 10 and Industrial 25 indices gained in Q2 by a more modest 3.2% and 4.1% respectively and 2.7% and 4.4% YTD, with a stronger rand undermining rand hedge shares. The rand strengthened in Q2 by 4.01% versus the US dollar, from R/$18.94 to R/$18.18, 0.9% stronger than the end 2023 rate of R/$18.34. Bond markets also fared well, helped by the prospect of continued fiscal prudence. The All Bond 1–3-year Total Return index gained 7.5% in Q2 and 5.6% YTD, while the 10-year government bond yield compressed from 10.61% at the end of Q1 to 10.21% at the end of Q2, albeit higher than the end 2023 closing level of 9.77%. Strong central bank buying led the gold price higher to $2323 per ounce from $2063 at the end of 2023.

The general election went ahead without violence or disruption and the ANC accepted its defeat. President Ramaphosa was re-elected and formed a centrist GNU with the DA, IFP and seven smaller parties, which excluded the EFF and MKP. The election results and the structure of the new government should ensure continuity of economic reform policy. The Bureau of Economic Research (BER) argued that the full implementation of Operation Vulindlela reforms could boost real GDP growth by 1.5 percentage points by 2029, lifting growth to 3.5% compared with the BER's 2% baseline forecast. Vulindlela has played a key role in opening up railways and ports to the private sector. The BER concluded that we do not need new initiatives or policies, what is needed is implementation. The newly formed cabinet includes a number of positive changes, with the DA's involvement imposing checks and balances on the ANC and ensuring economic and policy stability, which should lead to improved business confidence. Of the 32 ministerial positions, 11 went to the ANC's GNU partners, including six to the DA, two to the IFP and one each to the PAC, FF+ and PA. The DA has the capacity

to assert itself, especially in the Agricultural Department, in Communication and Digital Technologies, Public Works and Infrastructure, Home Affairs, Basic Education, and Forestry, Fisheries and the Environment, where it will lead the respective departments. The ANC also placed capable individuals in charge of the Police Department, Department of Trade, Industry and Competition, and Electricity and Energy, paving the way for greater policy reform implementation.

The current policy of fiscal prudence will continue, with Enoch Godongwana reappointed as Finance Minister. For the financial year ended March 2024, South Africa achieved a primary budget surplus, for the first time in 15 years amounting to R31.6 billion, or 0.4% of GDP. This means that income was more than expenditure, excluding interest, which is crucial in bringing debt under control. The government is committed to reducing the current 74% debt-to-GDP ratio. As well as maintaining a strict approach to funding state-owned enterprises, faster GDP growth would also be helpful in reducing the country's indebtedness.

The severity of loadshedding has eased. The 5th of July marked 100 days without loadshedding, the longest continuous period since 2020. Eskom's energy availability factor, as a percentage of maximum energy generation, improved from 53% in Q1 to 64% in Q2, attributed to several major units returning to operation. At the start of July, Eskom commissioned unit 5 at Kusile power station, adding a further 800MW to the grid. At the same time demand from the grid has eased as businesses and households have increasingly resorted to self-generated renewable energy solutions. The removal of licensing thresholds for new power generation projects and tax incentives for rooftop solar, have led to a surge to 5GW in installed rooftop solar capacity. Kgosientsho Ramokgopa, head of the newly configured Ministry of Electricity and Energy, said "Let's show the country and the rest of the world that we can do it. We are going to be the leaders on this continent in relation to renewable energy." Bank of America forecasts South African GDP could grow by 2% in the medium-term if Eskom maintains momentum and keeps the lights on.

In Q1, GDP shrank by 0.1% quarter-on-quarter, having expanded by 0.3% in Q4 2023. On a year-on-year basis growth slowed from 1.4% in Q4 to 0.5% in Q1. The unemployment rate also worsened from 32.1% in Q4 to 32.9% in Q1. Growth is expected to show a recovery in Q2 with the benefit of more reliable electricity supply, some improvement in port and rail logistics, and a lifting of political uncertainty. In April, both manufacturing and mining production gained year-on-year by 5.3% and 0.7%, respectively, compared with declines in March of 6.5% and 4.8%. The purchasing managers' survey data is a bit mixed, however. The Absa manufacturing purchasing managers' index (PMI) drifted from 54.0 in April to 45.7 in June, below the expansionary 50-threshold. The Standard Bank Whole Economy PMI fell from 50.4 in May to 49.2 in June. The PMIs may have been affected by delays in negotiating the GNU, which suggests some improvement in PMI data is likely over coming months. Business and consumer confidence data signal a pick-up in household and investment spending. The FNB/BER business confidence and building confidence indices increased between Q1 and Q2 from 30 to 35 and from 27 to 35, respectively. The consumer and retail confidence indices increased from -15 to -12 and from 34 to 39. The most recent South African Reserve Bank leading business cycle indicator increased a sizeable 2.4% in April, with eight out of the ten components showing an increase, led by the number of job advertisements, the number of building plans approved and the commodity price index for the country's main export commodities. Credit growth picked up in May with private sector credit extension increasing by 4.3% year-on-year, up from 3.9% in April. However, vehicle sales decreased by 14.0% on the year, reflecting high interest rates and constrained household finances.

Consumer demand should receive a boost in the second half of the year from the “two-pot” retirement reform, which will increase members’ access to the savings “pot” of their retirement funds. This frontloading of available consumer income is likely to boost consumption expenditure. There is scope for the SARB to cut interest rates, which should also boost domestic demand, as well as business spending. In his latest policy statement on 30th May, SARB Governor Lesetja Kganyago saw inflation stabilizing at the 4.5% objective in Q2 2025, earlier than the end of 2025, which had been predicted at the previous meeting in March. The revision is premised on better-than-expected CPI releases in March and April. With year-on-year headline and core CPI holding steady at 5.2% and 4.6% in May, there is a strong likelihood the SARB will cut its benchmark repo rate, currently at 8.25%, to 7.75% by year-end and to 7.25% in 2025. Real interest rates are high relative to the recent past and compared with other emerging markets.

The GNU coalition bodes well for a continuation of gradual economic reforms, and with other parties providing oversight, more efficient implementation, and greater policy stability. Business confidence is likely to improve, paving the way for much needed investment spending and increased productivity. At the same time, the economy stands to benefit from the broadening global economic recovery, increased trade volumes and export demand. There is scope for significant capital spending, making up for the years of prolonged economic stagnation and crumbling infrastructure. In the words of Dean Macpherson, the newly appointed Minister for public works and infrastructure, his vision is to transform South Africa into a “massive construction site.” An investment led growth model would repair the country’s infrastructure and at the same time create much needed employment. Provided the GNU can hold, South Africa’s equity market, which trades at a 20% discount to emerging markets, should re-rate from current oversold levels.

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