



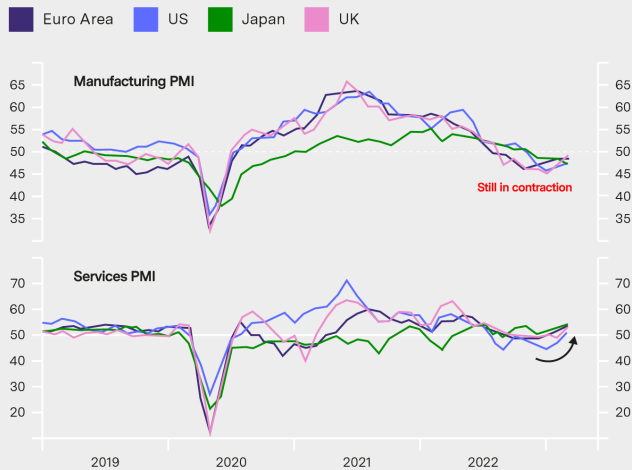
By Kyle Hulett
Head of Investments

February was local, with the State of the Nation Address (SONA), Budget and greylisting updates reflecting in the rand's significant weakening over the month.

Market review – The great rebalancing

The global economy continues to rebalance as reflected in the February Market Purchasing Manager Index (PMI) surveys (Chart 1). The PMIs show a strong improvement in services, while manufacturing remains in contraction. This is good news, because the excessive goods spending created by pandemic lockdowns and stimulus is unwinding as spending on services recovers. This should allow inflation to fall and protect growth, and it is consistent with our cautiously optimistic view that growth this year will not be terrible thanks to high consumer savings levels and pent-up demand. January's market moves discounted much of the good news, however, and stronger growth will sow the seeds for higher US inflation, which could lead to a recession in the US on the back of higher rates.

Chart 1: The great rebalancing



After January's euphoric performance, February markets digested the moves and contemplated the array of risks faced by the global economy despite more stable demand. Through February, we continued to monitor three key global macro risks. The first was the prospect of US inflation staying higher for longer, forcing the US Federal Reserve (Fed) to push the economy into a deep recession; the second was the expanding impact of the Russia/Ukraine war on global markets via energy costs; and the third was the lapse of judgement that sparked a geopolitical incident between China and the US. February brought no significant news on any of those risks, however: US inflation was only a little higher than expected, Russian forces made incremental progress in their assault on the Ukrainian city of Bakhmut and nothing emerged from the US and China's balloon races. In fact, most of the news in

US – Inflation headwinds remain

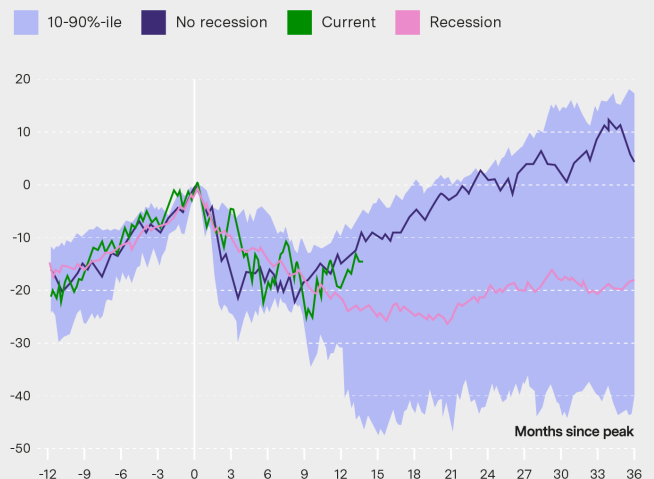
- **Inflation remains a stubborn foe for the Fed.**
- **Supply chains have recovered but remain an issue.**

The long-term outperformance of US stocks over European stocks has begun to roll over, but fundamental valuation differentials remain wide. US equity is trading at an average of 18 × earnings, while the EU and Japan are at about 12–13 × earnings and the UK is at 11 × earnings. In addition, US earnings will face downside pressure from dollar strength, rising wage pressure and anti-trust issues. The crowded higher-for-longer narrative around US inflation calls to mind the Great Inflation of the 1970s, a period of some of the highest and most prolonged rates of US price increases in history. This corroborates the suggestion of reversion between US and European stock valuation metrics, reflected in JPMorgan research showing that European stocks outperformed US stocks over long periods of the 1970s. While the EU, UK and Japan are not without their own headwinds, valuations reflect these to a greater extent.

So is this the Great Inflation 2.0?

US inflation fell to 6.4% in January 2023 (from 6.5% in December 2022), but consensus estimates centred around 6.2%, and the 0.1% YoY decline is the slowest in four months. Energy prices rose 8.7% YoY and food costs rose 10.1%, but shelter still contributed about 60% of the headline annual increase. Core CPI ex-shelter, a key focus index for the Fed, is cooling, which may tone down

Chart 2: US equities not pricing in a recession



hawkishness. However, the lagging impact of shelter's contribution to inflation means the Fed will also have to accept some higher inflation, at least until the shelter rollover filters through. Strong employment will add impetus to rate-hike rhetoric and the Fed will have to continue raising rates and accept higher inflation. Against flat expectations, the Fed's preferred metric, the Personal Consumption Expenditure Index, posted a 5.4% YoY acceleration through January. This reflects the expansive consumption patterns we have been expecting but is also an element of the inflation problem for which rate hikes are a likely response. Recent inflation surprises have eroded the optimism that existed in the relative disconnect between market and Fed forecasts, with July Fed swaps rising past the dot plot's terminal rate peak of 5.25%, to 5.31% (corresponding to a 70% chance of a third 25 bps hike in June). We continue to expect higher inflation, higher rates, lower growth and higher volatility for longer, resulting in a shallow recession. US equities are not pricing in a recession outcome (Chart 2).



By Mish-Al Bassadien
Portfolio Manager

China – Economic reopening continues, geopolitical risks remain

- **The property market appears to be reviving but not thriving.**
- **Tension over Russian aid and the “balloon” spying saga in the US.**

Recent house price data indicate that China's housing market is stabilising thanks to well-targeted policy from Chinese authorities (Chart 3). The Chinese Communist Party (CCP) has significantly stabilised the sector by implementing much of its 16-point property sector plan and other supportive measures. This stabilisation will support the Chinese economy, but restriction by authorities and natural property market headwinds will prevent any meaningful rebound in prices or construction. Because land is state-owned in China, authorities can use large state-owned commercial banks as policy vehicles to support or curtail the housing sector – the source of China's peculiar counter-cyclical loan approval schedule. True to form, the CCP is expected to enable and curb the property sector to promote quality expansion over boom-bust whiplash going forward. The painful lesson of a volatile property market has likely been learned, which will be good for stability and growth.

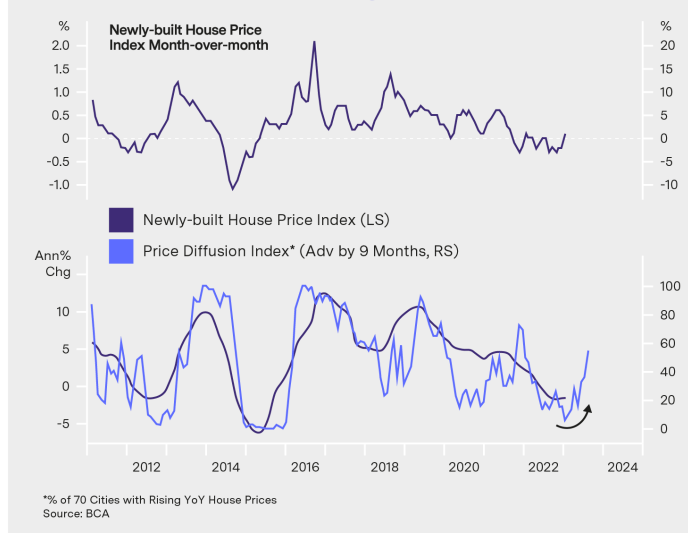
Economic growth in China...

The pent-up demand argument, as outlined in last month's Signals, is well worth a brief revisit, as China's GDP growth is likely to see a strong rebound in 2023. The Chinese consumer will be a key driver, with Standard Chartered estimating a 4% to 4.5% contribution from domestic consumption to annual GDP through 2023. Furthermore, the CCP's policy positioning remains abundantly favourable (with rate cuts on the table), contrasting starkly with the bulk of other global economic powers. Chinese money and credit data were stronger than expected in January as policymakers continued their frugal use of an encouraging amount of policy breathing room. In addition, M1 and M2 measures of money growth both accelerated past consensus estimates in January's figure. China is thus expected to maintain accommodative policy in the near term, enabled by low inflation.

Geopolitical risks remain...

Diplomatic relations between the US and China are souring. Geopolitical tensions remain a key risk and arguments against some form of stand-off between the two global superpowers are growing scarcer. A possible spy balloon incident skyrocketed tensions in February, causing the US to go on a shutdown frenzy that at one point saw a \$400 000 Sidewinder air-to-air missile pitted against a \$12 “hobby club” balloon over Canadian territory. Though the hobby club balloon was an overreaction ex post, the earlier “spy balloon” that originated in China led US Secretary of State Antony Blinken to cancel what would have been the first visit to China by a Biden administration cabinet secretary. Blinken and China's top diplomat, Wang Yi, subsequently exchanged verbal blows over the incident on the sidelines of a security conference in Munich. Unfortunately, the back and forth has reached beyond the balloons, as unrelated claims by the US included China's apparent intention to send weapons to Russia – a claim that China deflected by sending diplomats to both Ukraine and Russia to broker peace. In turn, China accused the US of a targeted political smear campaign and of mischaracterising Chinese efforts to productively cooperate with other nations.

Chart 3: China's housing market stabilises



South Africa – The state of multiple disasters

- **SONA delivers a chequered state of the nation report.**
- **Enoch Godongwana offers a reality check.**

The month of February ushered in President Cyril Ramaphosa's SONA and two states of disaster – one being Eskom and the other a series of floods that affected seven of nine local provinces. The SONA descended into chaos, diverting attention from SONA 2022's broken promises – namely the unbundling of Eskom by the end of that year and the formation of private partnerships to repair Transnet's Durban and Ngqura facilities by October 2022. With Transnet's beleaguered rail division having cost the country about R150bn in potential sales last year, it too is essentially an unavoidable near-future crisis. Eskom is the more immediate threat, however, and will be reporting to Cooperative Governance and Traditional Affairs Minister Dr Nkosazana Dlamini-Zuma. The new position of Minister of Electricity (in the



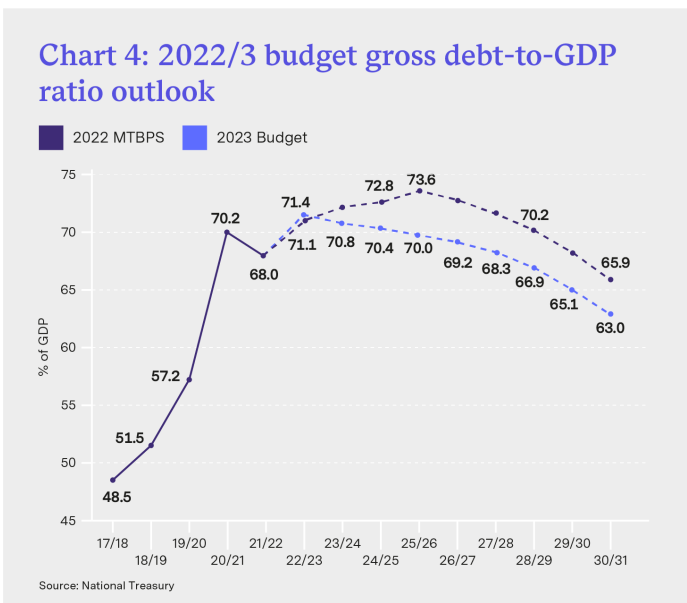
Presidency) is still to be appointed. The original structures remain in place, which the Democratic Alliance has argued will fragment the handling of the electricity crisis across four ministries (Minerals and Energy; Public Enterprises; Cooperative Governance and Traditional Affairs; and the Minister of Electricity in the Presidency) and further burden the taxpayer. The Department of Public Enterprises remains the shareholder ministry and will continue overseeing the unbundling of Eskom under Pravin Gordhan, while overall energy implementation will be handled by the Department of Mineral Resources and Energy under Gwede Mantashe. Eskom will also still have to deal with the National Energy Regulator of SA, and complicated reporting structures will cause extra expenses for citizens already suffering from the fastest-paced food inflation in the country in almost 14 years as diesel costs are passed on to consumers. Scathing reports of systematic and organised corruption at Eskom will likely attract greater scrutiny of Ramaphosa's imminent Cabinet reshuffle.

The budget...

Finance Minister Enoch Godongwana delivered a decent budget given the constraints. Government's fiscal position actually improved on higher-than-expected revenue collection (R93.7bn), but government debt is now forecast to peak at around 73.6% of GDP in 2025/6, much higher and later than previously announced, as a result of government taking on R254bn of debt from Eskom. Load-shedding relief came in the form of an extension of the diesel fuel levy refund to manufacturers of foodstuffs for a period of two years. For the next two years, companies can reduce taxable income by 125% of the value of the investment into renewable energy projects. A tax rebate to individuals for 25% of the cost of solar photovoltaic panels will also be available from 1 March 2023 to 29 February 2024, subject to certain conditions, to be capped at R15 000 per individual. The Covid-19 Social Relief of Distress grant has been extended until 31 March 2024.

The greylisting...

The Financial Action Task Force (FATF) has placed South Africa on its so-called grey list. This classification system is an intergovernmental effort aimed at curtailing money laundering and terrorist financing through increased monitoring of higher-risk jurisdictions. The implications of the greylisting will likely reflect in subdued foreign investor appetite. Companies transacting/investing across South African borders will likely incur higher costs to do so, which will put upward pressure on the cost of living inside the country. Finally, increased uncertainty will likely reflect in a greater cost of capital



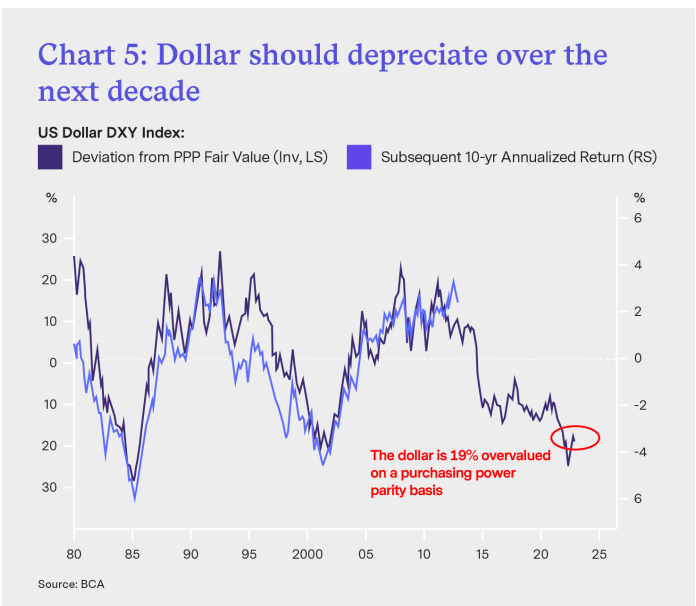
through higher risk premia on local assets. Other countries on the grey list include known tax havens such as the Cayman Islands and Panama and war zones such as Syria, Mali and Mozambique. Breaking free from the grey list will require additional legislation, investigative funding and the effective prosecution of financial crimes.



By Iain Anderson
Head of Investments

Outlook

US retail sales in January rose by their most in nearly two years, confirming the strong consumer. Barring any surprise risks from geopolitics, the main risk to the global economy is from central banks (mostly the Fed) pushing the world into recession with overaggressive monetary policy. This will generally only happen against the backdrop of a strong economy (underpinned by strong corporate earnings) or if inflation expectations become unanchored and start to rise. Current forecasts suggest the contrary: a weak US economy with weak earnings and stable inflation expectations. We therefore expect to see moderated policy conviction in the nearer term at least, which will only change if a combination of strong economic data and a reacceleration of inflation materialise to reignite the Fed's rate-hike resolve. While a US recession is likely, we still only see its emergence as probable in Q4 2023 or early in 2024.



Reintroducing geopolitics into the equation presents a significantly more fragile picture. Russia has announced it will cut crude oil production, ostensibly because of Western sanctions on Russian fuel exports, but most likely because it is producing fuel faster than it can sell it on the shadow market. China and the US will likely continue to bicker, but we expect relative resilience from both economies as the geopolitics unfold. US resilience will probably lead to near-term strength in the dollar, given that two-year interest rate differentials are moving in the dollar's favour. Longer term, the dollar remains expensive on a purchasing power parity basis and should depreciate. We have put additional protection measures in place in expectation of heightened volatility into the second quarter.



Key indicators

		1 mo.	3 mos.	6 mos.	1 yr.	2 yrs.	3 yrs.	5 yrs.	10 yrs.
J203T	FTSE/JSE All Share Index	-2.2%	4.1%	17.6%	6.2%	13.1%	19.5%	9.8%	10.5%
J200T	FTSE/JSE Top 40 Index	-2.4%	4.7%	19.9%	6.8%	13.2%	20.4%	10.7%	10.8%
J210T	FTSE/JSE Resources 10 Index	-13.2%	-10.4%	10.6%	-18.2%	5.6%	22.9%	18.8%	7.2%
J211T	FTSE/JSE Industrials 25 index	1.7%	15.2%	26.1%	23.0%	11.9%	18.4%	8.3%	11.8%
J212T	FTSE/JSE Financials 15 Index	2.5%	1.1%	13.9%	9.6%	21.6%	11.6%	2.5%	8.5%
J403T	FTSE/JSE SWIX Index	-2.3%	1.9%	13.2%	4.0%	9.4%	14.7%	5.8%	9.0%
J433T	FTSE/JSE Capped SWIX Index	-2.3%	1.6%	12.8%	3.8%	13.0%	16.5%	6.1%	8.8%
J303T	FTSE/JSE CAPI Index	-2.5%	3.4%	16.7%	5.8%	14.9%	20.4%	10.0%	10.5%
J253T	FTSE/JSE SA Listed Property Index	-0.7%	-0.6%	9.9%	5.1%	13.4%	2.7%	-3.6%	2.0%
ALBI	JSE All Bond Composite Index	-0.9%	2.7%	5.6%	4.9%	7.0%	7.4%	7.1%	7.2%
STeFI	STeFI Index	0.5%	1.7%	3.2%	5.7%	4.8%	4.8%	5.8%	6.2%
	MSCI World Index in SA Rands	2.8%	8.1%	12.1%	10.1%	11.5%	15.6%	16.8%	16.8%
	Rand/US Dollar Exchange Rate	5.3%	8.0%	7.7%	18.8%	10.1%	5.2%	9.3%	7.4%
	Rand/Euro Exchange Rate	2.9%	11.2%	13.6%	12.2%	2.9%	3.8%	6.2%	5.1%
	Rand/Pound Exchange Rate	3.6%	9.8%	12.1%	7.2%	2.4%	3.2%	6.5%	5.0%
	Headline CPI	-0.1%	0.6%	1.2%	6.9%	6.3%	5.2%	4.8%	5.2%
	PPI	-0.6%	-0.1%	0.6%	12.7%	11.4%	8.7%	6.9%	6.4%

