The Monthly Bulletin

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November 2023

Prof. Bhorat's column this month: Sovereign debt crises are resurging globally, worsened by Covid-19's impact on economies and complicated by a diverse array of creditors.

Discover external debt in low- and middle-income countries by creditor type from 1980–2019.

Market review

By Kyle Hulett
Co-Head: Investments

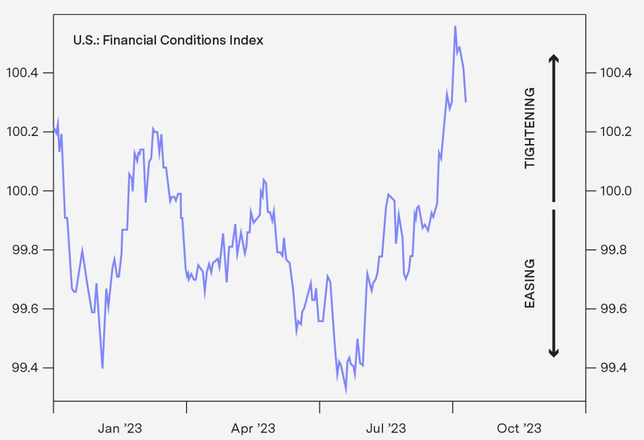
The Hamas attack and Israel's response to it have taken a heavy human toll, and more lives will be lost if the war spreads. United Nations Secretary-General Antonio Guterres warned that the Middle East is on the "verge of the abyss". The war between Israel and Hamas introduces a new geopolitical risk for global investors, on top of the ongoing Russian-Ukraine war, and increases the probability of higher oil prices driving markets into recession. The US 10-year bond yield, a key benchmark for global interest rates, soared over 5% to its highest level since 2007, pushing the US dollar to one-year highs. This is a sign of growing investor angst as geopolitical risks rise and central banks are forced to maintain tight monetary policy due to higher-for-longer inflation. The International Monetary Fund has lifted its global inflation forecast for 2024, with inflation remaining above central bank targets until 2025. The sharp rise in bond yields and the overall tightening in financial conditions since August is equivalent to approximately 0.75% of Fed rate hikes. This is likely to lead to a more dovish Federal Reserve. "It's clearly a tightening in financial conditions," Fed Chair Jerome Powell said. It will take longer for rate hikes to take effect than before, as many individuals and companies locked low rates in for the long term, and some companies, like the tech platforms, are cash rich and benefit from higher rates. Similarly, global growth has stabilised, with the US remaining resilient, Chinese activity surprising to the upside and tentative signs of a European manufacturing recovery. Thus, while bond yields are showing more value, we are in a higher-for-longer world, which includes higher normalised bond yields. Bond proxies such as Healthcare, Utilities and Staples have been hurt alongside bond prices, but gold rallied close to record highs of $2 000 an ounce as a geopolitical safe haven and bitcoin surged in the month, rising above $35 000 on speculation of the first US spot bitcoin ETF being approved in the coming weeks.

US – Headwinds to growth even as inflation moderates

- **Strong Q3 with 4.9% GDP growth, but facing a slowdown due to cooling inflation, high mortgage rates and increasing loan delinquencies.**

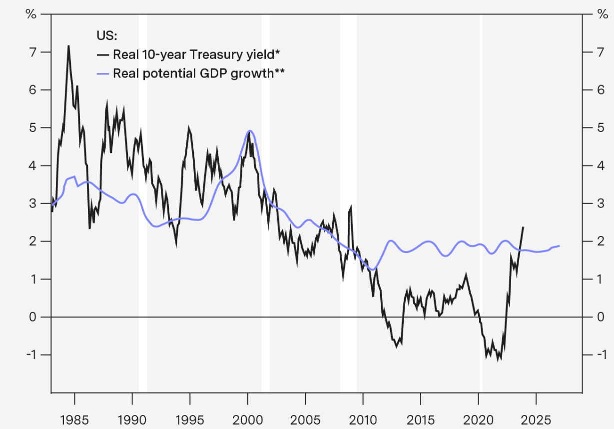
The US remains resilient, with Q3 GDP jumping to 4.9% annualised and being supported by a strong consumer. We do not expect a recession, but a slowdown is underway and is cooling inflation. Core personal consumption expenditure fell to 2.4% – lower than expected, and its lowest level since 2020. Growth is poised to slow in the coming months, which is not surprising given the higher mortgage rates. The US 30-year mortgage rate reached 8%, its highest level since November 2000. Applications for new homes have collapsed as higher mortgage rates make housing unaffordable. Similarly, subprime vehicle loan delinquencies are at their highest in the 30 years of relevant data. The primary driver of the move in government

Chart 1: The Fed should not need to raise rates further given the tightening in financial conditions



Source: Goldman Sachs

Chart 2: US real yields rise above potential growth



* Tips Yield, with Historical Extrapolation Calculated as the Nominal Yield minus the BCA Adaptive Inflation Expectations Model. **Source: Congressional Budget Office (CBO).
Source: BCA

bond yields has not been inflation expectations but the real yield. Real potential GDP has historically been an anchor for real yields, as 10-year yields are viewed as being driven by long-term structural economic growth. The real US 10-year yield breached 2.5%, higher than the 1.8% indicated by the US Congressional Budget Office estimate of potential growth. Thus, while interest rates may be high at present, they are close to fair levels. US small caps are showing the impact of higher interest rates and, based on forward price-to-earnings ratio, are at their cheapest relative to large caps since 2001. Similarly, the S&P 500 Equal Weight Index is now negative year to date, about 14% below the actual market cap-weighted S&P return. Higher interest rates are slowing growth in various indirect ways. Below-inflation wage increases have caused 45 000 United Auto Workers to strike nationwide, and more than 75 000 Kaiser Permanente workers began striking in the largest US healthcare walkout in history.

Interest costs are also focusing attention on the budget deficit. Republican Kevin McCarthy became the first House Speaker to be ousted from the position and was replaced by Mike Johnson, best known for his support of Trump's efforts to deny the 2020 presidential election results. BCA estimates that the odds of a US government shutdown are up to 50%. The next deadline to fund the government is 17 November, and a prolonged shutdown will further slow growth.

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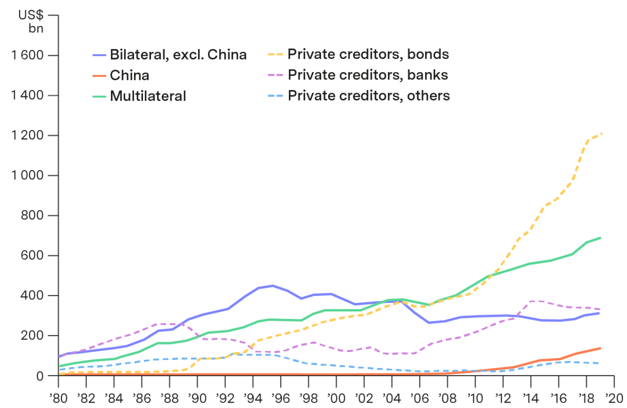
Sovereign debt distress is back – but this time it's different!

By Professor Haroon Bhorat
Investment Committee Advisor

Just when you might have thought it was safe to only focus on inflation and low growth around the world – sovereign debt crises have made an unfortunate comeback, with some clear boiling points already having been reached in Zambia, Sri Lanka, Ghana and Argentina. The Covid-19 pandemic led to a dramatic increase in sovereign debt, with the average total debt burden among low- and middle-income countries increasing by roughly 9% of GDP in 2020, compared to an average of about 2% over the previous decade. Indeed, the average debt stock of countries eligible for the Group of Twenty (G20) Debt Service Suspension Initiative (DSSI) increased from 50% to 57% of GDP over the last few years. By 2019, half those countries were at high risk of debt distress.

Factoid: External debt in low- and middle-income countries by creditor type: 1980–2019



Note: The figure shows total public and publicly guaranteed external debt by creditor type in low- and middle-income countries. The data are for 120 low- and middle-income countries, of which 73 are low- and lower-middle-income countries.
Source: BCA

We have seen this movie before, but there has been a significant change in the composition and complexity of sovereign debt in developing countries this time around. In the past, countries only really had to deal with the International Monetary Fund and the World Bank as creditors, who, together with advanced countries in the Paris Club, could collectively search for solutions to debt crises. It was tough, but optimal debt management structures and procedures were in place. Now, however, creditors have multiplied, and private non-Paris Club creditors – including foreign governments, quasi-sovereign entities, SOEs and corporations not traditionally engaged in sovereign lending (such as commodity traders and producers) – dominate the sovereign debt landscape.

China's entry into global debt markets has been another key development. Whereas in 2000 China accounted for 0.4% of the debt stocks of low- and middle-income countries, by 2019 it accounted for 4.8%. For low- and lower-middle-income countries specifically, China accounted, on average, for 11% of total external public and publicly guaranteed debt, rising as high as 66% for some countries.

While it is good to diversify, this scenario offers three stark challenges. Firstly, the rise in the number of creditors has made the co-ordination of payments, rescheduling of debt, etc. much more difficult. Secondly, concern is rising about the lack of transparency around debt contracted with non-Paris Club lenders. In particular, a proliferation of debt has been taken on by state-linked institutions such as SOEs, regional governments and the like, which has obscured the true nature and extent of a country's sovereign debt. For example, debt issuance by SOEs and subnational entities grew sevenfold between 2009 and 2019, to about $140 billion. And lastly, as a consequence of the first two factors, the average indebted country must now manage and oversee a toxic cocktail of debt instruments – which in a distressed environment can be lethal for macroeconomic stability. Creditors thus carry different interest rate obligations, legal structures, default penalties, amortisation schedules and so on – which in more colourful arrangements such as commodity-based lending can, as the World Bank notes, "run the risk of countries mortgaging their futures to commodity brokers". A recent report on debt transparency found that commodity-based lending represents 10–30% of external debt stocks for the median low-income country in the year following its signing of a commodity-based arrangement.

Given that these creditors are not only heterogenous but also difficult to co-ordinate, debt solutions are much more difficult for governments to manage, renegotiate and restructure. We have seen sovereign debt crises before, but its features – and possibly its multiplier effects – are likely to be very different this time.

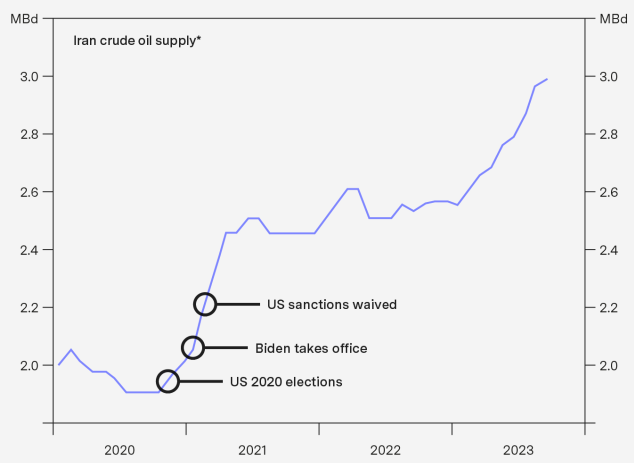
The market impacts of the Israel/ Hamas war

- **Prolonged conflict elevating geopolitical risks and market volatility, with limited but notable impact on global economic growth.**

The Israel/Hamas conflict is likely to last longer than initially expected, leading to heightened geopolitical risk and market volatility. Our base-case scenario sees a relatively small impact on global economic growth, provided Israel's response is focused on Gaza and has limited regional escalation, with only minor engagements with Hezbollah and other militant groups in Lebanon and Syria. This would satisfy Israel's securities needs and restrict Iran's engagement to indirect methods via militant proxies. The US Congress is pressing for additional oil sanctions on Iran, but these are not supported by the Biden administration. If enacted, they could limit Iranian oil exports and affect prices, assuming Saudia Arabia did not compensate. The oil price has been flat since 6 October, but the global oil markets are already tight, and Russian and Iranian supply could both fall 1 million barrels/day. Saudi Arabia and the UAE are preparing for a quick restoration of production and could restore 2.5 million barrels/day currently being withheld from markets, but the price could spike in the short term before production is back online. There is a small chance of Israel attacking Iranian assets (particularly their nuclear facilities), which would have a major impact on oil supply. Supply would be halted due to the critical importance of chokepoints such as the Suez Canal, the Bab al-Mandab and the Strait of Hormuz, which could drive oil prices to $150 a barrel.

Not only is this conflict increasing East/West tensions, it complicates the new BRICS+ arrangement. In 2001, the five BRICS economies held 19% of global GDP in purchasing power parity terms. Including the countries set to join, the collective share today is 36%, with Bloomberg forecasting a rise to 45% by 2040 – more than double the weight of major advanced economies. BRICS' rapid rise is transforming the global economy, but members are, in general, less democratic and free-market than advanced economies, and the bloc's lack of consensus will frustrate its creation of a common currency, while China's relative strength will continue to dominate the group.

Chart 3: Reintroducing US sanctions could cut Iranian oil flows



Source: Alpine Macro

China makes rare midyear adjustment to the budget

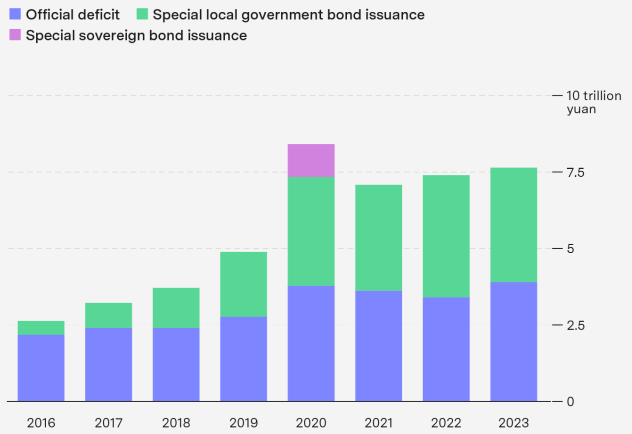
- **Exceeding GDP growth forecasts at 4.9% despite a weak property sector, showing strong consumer demand.**

China's economy gained momentum in the third quarter and its GDP expanded 4.9% year-on-year, beating market expectations of 4.5%, but the property market continues to weigh on growth. Chinese property stocks are at their lowest level since 2009, and China's economic recovery remains highly uneven. Housing-related activity remains weak, but consumer services are buoyant. China had record-high tourism revenue at its week-long National Day, and consumer spending increased on everything from restaurants and alcohol to cars, underscoring resilient consumer demand. Despite the improvement in momentum, China made a rare midyear adjustment to its budget, which it last did during the 2008 Great Financial Crisis, and before that in the Asian Crisis of the late 1990s. China raised its budget deficit for 2023 by at least 1 trillion yuan, approximately 0.8% of GDP, and passed legislation to raise the 2023 budget deficit above the ceiling of 3% of GDP, to 3.8%.

The equity market has not been a believer in China's targeted policy response so far, however, and China's CSI 300 Equity Index fell below its March 2020 Covid low in October, bringing its loss since the February 2021 peak to -40%. While it rallied on the news of support, it remains to be seen whether this will be enough to counter the property sector.

> "China raised its budget deficit for 2023 by at least 1 trillion yuan, approximately 0.8% of GDP, and passed legislation to raise the 2023 budget deficit above the ceiling of 3% of GDP, to 3.8%."

Chart 4: China's fiscal gap much bigger when special bond sales are included



Source: Bloomberg

South Africa – Collapsing SOEs impacting political polls

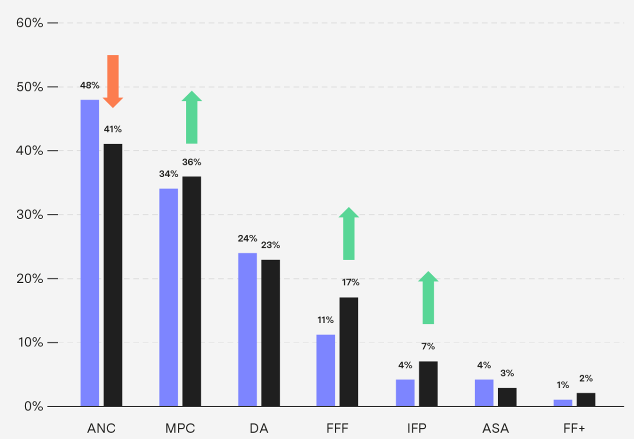
By Steven Empedocles
Head: Indexation

- **ANC support declining against escalating infrastructure crisis and economic challenges, while coalition prospects with the EFF grow amidst mounting government debt and a pivotal upcoming budget policy statement.**

Brenthurst political polls show the ANC's support dropping from 47% to 41% over the past year against a backdrop of an infrastructure and service delivery crisis. Support for the Multi-Party Charter, an electoral pact that includes the DA, IFP, ActionSA, FF+ and the UIM, rose to 36% – only 5% behind the ANC. EFF support improved from 11% to 17%. Wits Business School Professor Jannie Rossouw stated that South Africans have gotten poorer over the last decade, with the population growing at an average rate of 1.8% per annum and the economy at 1%, meaning that per capita GDP, a proxy for average wealth, has fallen in rand terms. Rossouw concluded that "Government's policies over the last ten years have simply not delivered the desired results." Transnet is looking close to total collapse and has requested a R100bn rescue package from National Treasury. The coal line is back to 1996 levels. The CEO of its freight rail division, Siza Mzimela, resigned in October, joining the exodus of group CEO Portia Derby and CFO Nonkululeko Dlamini. Government has mentioned possible solutions that would include the private sector, but they appear to be backtracking on this. With dwindling support, there is a risk that the ANC will form a coalition with the EFF, which would lead to the inclusion of EFF leaders in top government positions and the adoption of some of its populist policies. The silver lining is that low growth has kept inflation at bay, with core inflation falling to 4.5%, in line with the target rate.

The Medium Term Budget Policy Statement was announced today, with Finance Minister Enoch Godongwana declaring "Our public finances are significantly weaker." South Africa's debt-to-GDP has risen 47.2% over the last 15 years, compared to the average emerging market increase of 22.7%. With higher interest rates, this has driven the share of government expenses on interest payments to unsustainable levels. SA expects to collect R56.8 billion less tax than planned as a result of lower growth and corporate tax. Expenses overshot by 10% due to a higher wage bill and debt service costs rose to a staggering R354bn. This will push gross debt to above R6 trillion by March 2026, where it should stabilise at 78% of GDP. No money was allocated to Transnet, but the Covid welfare grant was extended by another year. Taxes are expected to be raised in February to collect an additional R15 billion. With growth already non-existent, higher taxes are most unwelcome.

Chart 5: Brenthurst Polls show ANC dropping to 41%



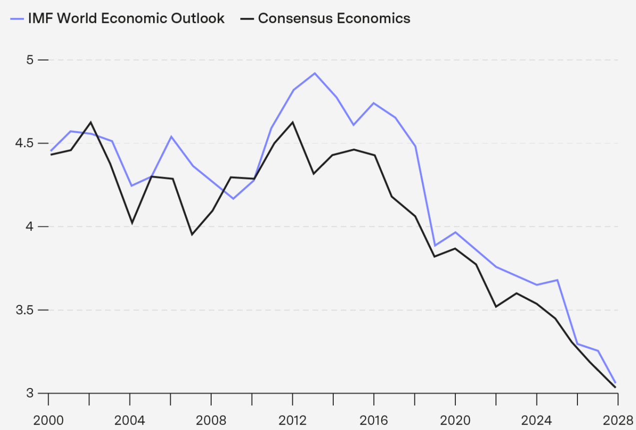
Source: Daily Maverick

Outlook

By Iain Anderson
Co-Head: Investments

Our base case remains a soft landing. The latest data point to stronger US households and business, with wages and profits growing faster than expected as nominal GDP growth exceeds expectations. Household excess savings have also been revised higher, and the disbursement of funding in the US from the Inflation Reduction Act and the Creating Helpful Incentives to Produce Semiconductors Act will support demand for years. That said, consumers and companies face headwinds from higher interest rates, though this may take longer to take effect than previous cycles. Stocks are oversold, and an improvement in global manufacturing conditions may contribute to a period of outperformance for risk assets. However, equity multiples are likely to be repriced lower on higher-for-longer interest rate outlooks and geopolitical risks remain high, so we prefer to remain conservatively positioned, especially as the long-term forecast for growth continues to be downgraded.

Chart 6: IMF medium-term world outlook shows slowing growth



*Year for which forecast is made, 5yrs prior
Source: Financial Times

Key indicators

		1 mo.	3 mos.	6 mos.	1 yr.	2 yrs.	3 yrs.	5 yrs.	10 yrs.
J203T	**FTSE/JSE All Share Index**	-3.4%	-10.4%	-9.2%	8.3%	5.8%	15.0%	9.8%	7.9%
J200T	**FTSE/JSE Top 40 Index**	-3.7%	-11.8%	-10.4%	10.0%	6.5%	14.8%	10.6%	8.1%
J210T	**FTSE/JSE Resources 10 Index**	-4.3%	-12.6%	-18.6%	-8.4%	-1.5%	11.5%	11.4%	5.1%
J211T	**FTSE/JSE Industrials 25 index**	-4.6%	-13.4%	-10.6%	21.5%	5.7%	10.6%	10.4%	8.2%
J212T	**FTSE/JSE Financials 15 Index**	-2.2%	-7.6%	2.3%	6.3%	11.5%	24.0%	4.7%	6.8%
J403T	**FTSE/JSE SWIX Index**	-3.0%	-10.5%	-8.8%	3.7%	2.8%	11.0%	6.9%	6.3%
J433T	**FTSE/JSE Capped SWIX Index**	-2.9%	-10.3%	-8.7%	3.1%	3.4%	14.3%	6.8%	6.2%
J303T	**FTSE/JSE CAPI Index**	-3.4%	-10.3%	-9.1%	7.2%	5.6%	16.5%	9.6%	7.9%
J253T	**FTSE/JSE SA Listed Property Index**	-3.0%	-6.1%	-8.2%	-1.3%	0.8%	19.1%	-3.8%	0.9%
ALBI	**JSE All Bond Composite Index**	1.7%	-0.9%	0.9%	7.9%	5.5%	7.3%	7.9%	7.3%
STeFI	**STeFI Index**	0.7%	2.1%	4.1%	7.7%	6.2%	5.4%	5.9%	6.4%
	MSCI World Index in SA rands	-3.4%	-4.4%	0.9%	12.7%	5.4%	13.4%	13.6%	14.4%
	Rand/US dollar exchange rate	-0.5%	5.4%	2.5%	2.0%	11.1%	4.9%	4.9%	6.4%
	Rand/euro exchange rate	-0.7%	1.1%	-1.8%	9.1%	6.1%	1.5%	3.5%	3.8%
	Rand/pound exchange rate	-1.1%	-0.6%	-1.0%	7.5%	4.5%	2.7%	3.8%	3.5%
	Headline CPI	0.6%	1.8%	2.6%	5.4%	6.4%	5.9%	5.0%	5.1%
	PPI	1.5%	2.8%	3.1%	5.1%	10.6%	9.7%	7.1%	6.4%