The Monthly Bulletin

SygniaSygnals

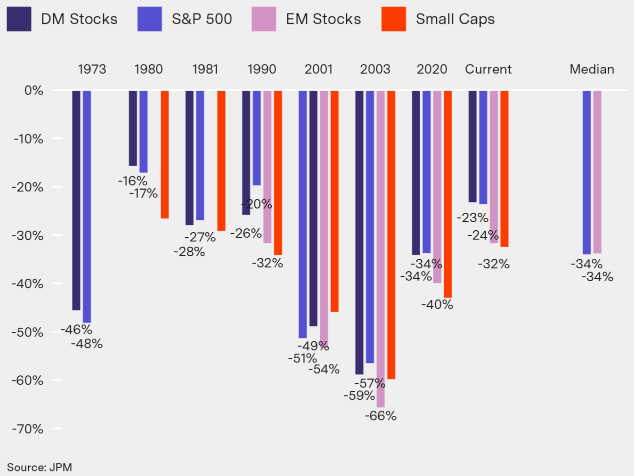
August 2022

By Kyle Hulett
Head of Investments

Market review

Markets bounced in July despite dramatic economic and political events. Inflation surged around the globe and growth forecasts plummeted. The day after a dramatic loss of confidence led to Boris Johnson's resignation as British Prime Minister, Japan's longest-serving former prime minister, Shinzo Abe, was murdered in a country with one of the lowest murder rates in the world. This was followed by Italian Prime Minister Mario Draghi's resignation, dumping Italian politics into chaos after a fracture in his unity coalition. Global equity markets fell early in the month, and small caps and emerging market stocks retreated by as much as the median fall in recessions over the last half century. Chart 1 compares these stocks to developed markets (which have fared better).

Chart 1: Small caps, S&P 500, EM and DM stocks vs past recessions



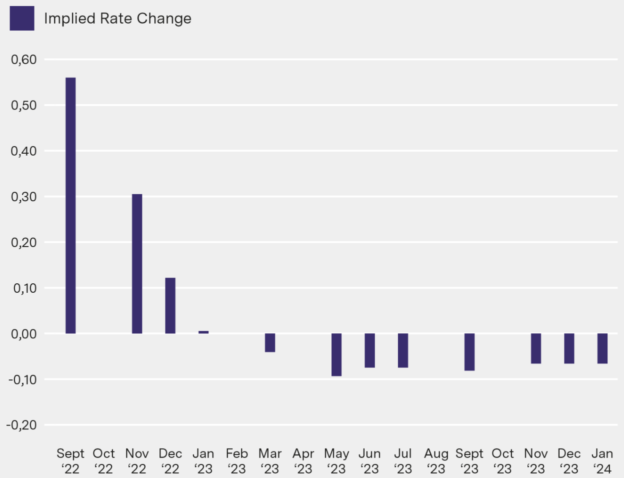
Source: JPM

US – Entering a technical recession but economy looks resilient

- **US economy shrinks after first quarter woes.**
- **Dollar rebounds strongly against the pound.**

The debate around the likelihood of a US recession ended in July when the US economy shrank -0.9%, following its contraction in the first quarter. However, like the first quarter, the decline was largely due to a sharp swing in inventory. Personal consumption and labour data remained strong, with June's total non-farm payroll employment numbers rising by 372 000. While at face value this signals a strong economy, it also gives the Fed much-needed space to battle inflation. US CPI climbed 9.1% higher than a year ago, its fastest climb since 1981. Inflation also proved perniciously broad-based, as three-quarters of the CPI components surged from May to June at an annualised rate faster than 4%. Markets responded with fervour, most evident in assets sensitive to a change in the pace of rate hikes. The S&P 500 fell and the dollar strengthened to parity with the euro for the first time since 2002 and to its strongest against the pound since 1984. Gold fell 16% below its March highs. While the broad-based nature of the June number is negative for the outlook, it is important to note that core CPI is still lower than its March peak. CPI is also a lagging indicator, and the June shock did not include the effects of the Fed's recent 75 bps hike. Brent oil is down more than 20% from its March peak, and metal commodities are down 27% from their April peak. With the recent dollar strength, cheaper metals and crude are likely to have a strong deflationary effect on July's CPI. In this light, long-term inflation expectations from US consumers declined in July to only 2.8% over the next five to ten years (down from 3.1% in June and the lowest in a year). Similarly, while the Fed hiked another 75 basis points in July, there were no hawkish surprises. In fact, although interest rates are expected to be 1% higher by year end, the market is already pricing in the first rate cut for March 2023 (Chart 2), only six months away.

Chart 2: Implied policy increases



Source: Bloomberg

Finally, the case for a US recession is most strongly reflected in the 10y–2y T-bill curve's inversion. Fortunately, the US leading economic indicator is still positive at 1.4. Given inflation has an easy path back to 4%, we do not think the Fed will hike more than expected this year, allowing a soft landing. However, a move to 2% inflation will require a higher unemployment rate, and 2023 could see more volatility.

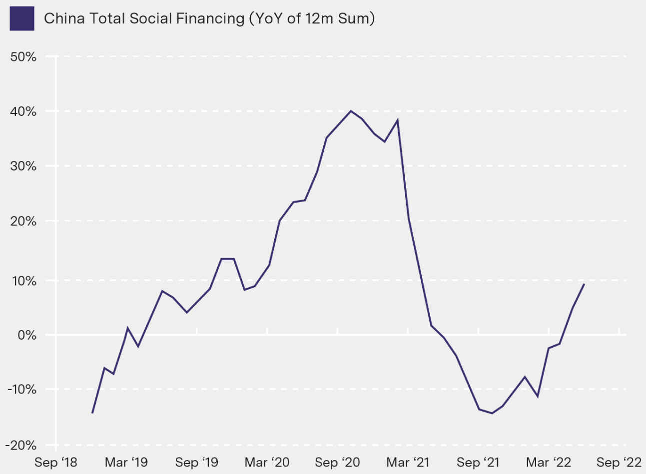
By Chanté Burger
Portfolio Manager

China – Special bonds will accelerate infrastructure spend

- **China fights Covid and bond default flare-ups.**
- **Local governments access special bonds to support the economy.**

The People's Republic of China started July by putting out fires around everything from a Covid flare-up in Shanghai to a bond default flare-up in its property sector. In contrast to the US, the theme of roaring Chinese economic stimulus is still very much underway. China's total social financing is the broadest measure of new credit, with June data showing a strong rebound in credit demand. Aggregate financing was significantly above expectation, surging to CNY5.2 trillion from CNY2.8 trillion in May and demonstrating the impact of the country's incrementally rising credit and fiscal easing.

Chart 3: China total social financing



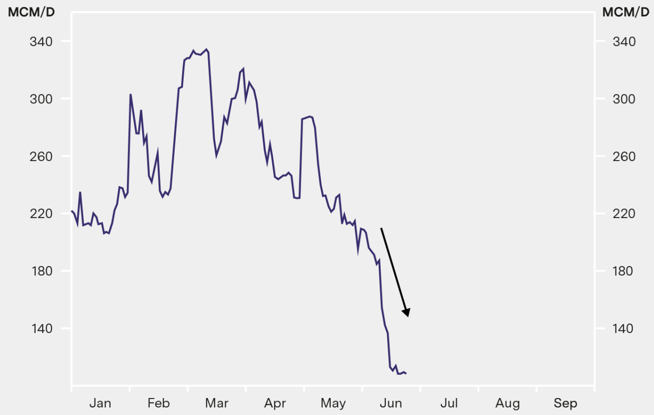
Source: Bloomberg

The Chinese Ministry of Finance will consider allowing local governments to issue a chunky $220 billion of special government bonds in the second half of 2022, an additional 40% relative to the original amount. These special bonds will be used to accelerate infrastructure funding and further support the economy. This is the first time that bond issuance will be fast-tracked this way, with the additional notes being brought forward from next year's quota. Government and policy banks are making over ¥7 trillion available for projects, demonstrating China's preference for fiscal measures to stimulate the economy. The PBOC's rate-easing path remains cautious, with no rate cut since January and one-year policy loan rates still at 2.85%. The CSI 300 index is still down about 27% from its peak from before policymakers started their big tech crackdown around 17 months ago. The index is about 26% behind the S&P 500, incentivising the contrarian argument in favour of Chinese equity with some downside protection by virtue of sheer cheapness. While emerging markets (EM) still face headwinds caused by the strong dollar, money supply growth in EMs continues to outpace developing markets, which is a positive sign for stronger EM growth.

Russia/Europe – Natural gas poses risks

- **Russian natural gas supply to Europe slows down.**
- **Russia and Ukraine restart grain export.**

Chart 4: Flows of Russian natural gas to Europe decline due to "maintenance"



Note: Calculated as the sum of flows via Nordstream 1, Turkstream, Yamal and pipelines from Russia to Ukraine.
Source: BCA

Energy supply continued to dominate the European narrative throughout July. Crude oil prices have moved considerably lower as heightened recession risks spilled over into lower oil demand forecasts. However, Russia could still weaponise its energy supplies, particularly its gas. Russia's current account surplus widened to a record $70 billion in the second quarter due to skyrocketing energy prices, the widest surplus since 1994. According to the International Energy Agency, Russia's oil shipments have declined by only 5% since January despite sanctions. There is little pressure on Russia to meet European demand, and Russian natural gas flows to the EU slowed in recent weeks – supposedly because of routine maintenance issues. Irrespective, Nord Stream 1 (the EU's biggest gas import infrastructure) was temporarily shut down. Russia has resumed its shipments to Europe via the Nord Stream pipeline, but it is only operating at 40% capacity.

> Energy supply continued to dominate the European narrative throughout July.

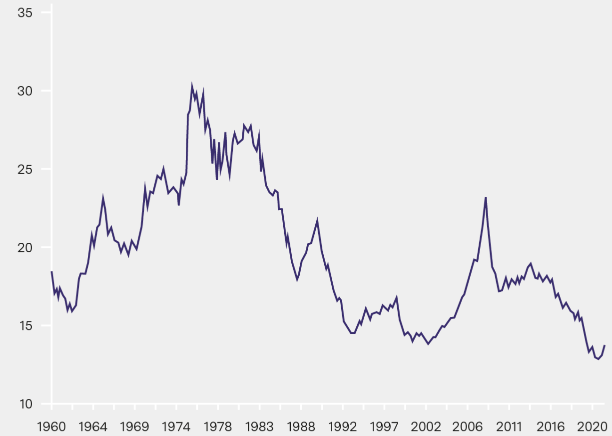
Oil continued to flow out of Russia at the target rate, most likely because it accounts for a far greater share of Russia's exports. If Russia does weaponise its natural gas supply, Europe will be pulled down into a deep recession, cutting GDP by a further 1.5% and possibly taking the global economy with it – even in a base case where China's growth continues to recover. On the positive side, Russia and Ukraine, who account for nearly 30% of global wheat exports, signed a UN-backed agreement that enables them to restart their grain exports. Germany, Italy, Austria and the Netherlands have signalled that they may restart coal-fired power plants, while Japan has ordered the restart of up to nine nuclear reactors. The outlook remains highly uncertain.

South Africa – Heading for an Arab Spring

- **Lack of service delivery could lead to unrest.**
- **Inflation rises due to higher energy prices and a weak rand.**

Former president Thabo Mbeki has warned that South Africa is heading straight for an Arab Spring revolution. With no end in sight, he has cautioned that a lack of service delivery is likely to lead to further unrest, as “we do not have an agreed national plan to address these challenges” – referring to the social compact that Ramaphosa promised would come to fruition within 100 days of his February State of the Nation Address.

Chart 5: South Africa fixed capital formation to GDP



Source: Bloomberg

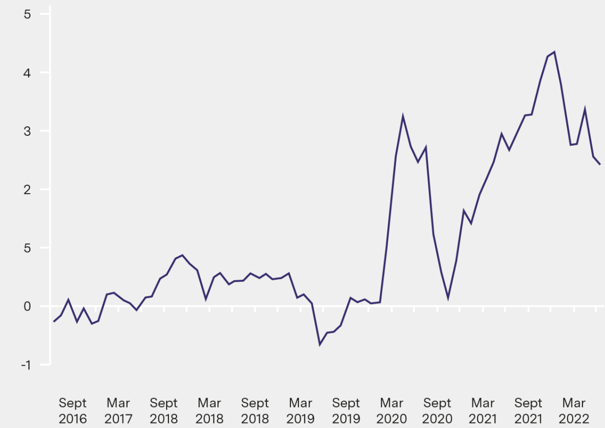
Inflation rose to a 13-year high of 7.4% on the back of higher energy prices and a weak rand, but core inflation remained muted at 4.4%. Inflation is unlikely to remain high, because demand in South Africa is low as a result of weak growth, which is dependent on investment. Fixed capital formation remains dismal at 13.7% of GDP, well below the government’s target of 30%, and investment will stay low until a stable power supply is available. The SARB raised the repo rate ahead of expectations, from 4.75% to 5.50%.

By Iain Anderson
Head of Investments

Outlook and positioning

In light of the current global economic status quo, the lower base on various equity markets provides some downside protection. The latest Bank of America fund manager survey shows markets at peak bearishness, with fund managers holding their highest cash levels since 2001. The Global Supply Chain Pressure Index (Chart 6) reflects easing supply chain pressures, suggesting that we may have seen the worst of inflation. It is likely to remain elevated, however, depending on Russia’s behaviour in Europe. Without losing sight of the current elevated risk, we foresee a global growth recovery in the second half of 2022. While China will probably lead this recovery, it is likely to be underpinned by the moderation in inflationary forces that, in turn, will allow central banks to be less hawkish into year end. However, as inflation is likely to be sticky, 2023 could see further hikes. Markets are likely to remain highly volatile as growth slows, while inflation uncertainty remains high.

Chart 6: Global Supply Constraint Pressure Index showing some relief



Source: Bloomberg

Key indicators

		1 mo.	*3 mos.*	*6 mos.*	*1 yr.*	*2 yrs.*	*3 yrs.*	*5 yrs.*	*10 yrs.*
J203T	**FTSE/JSE All Share Index**	4.2%	-4.5%	-5.2%	4.7%	15.4%	10.6%	8.2%	10.6%
J200T	**FTSE/JSE Top 40 Index**	4.0%	-4.4%	-5.9%	4.1%	14.3%	11.0%	8.6%	10.9%
J210T	**FTSE/JSE Resources 10 Index**	0.8%	-16.8%	-10.4%	-2.2%	13.9%	18.6%	18.8%	7.6%
J211T	**FTSE/JSE Industrials 25 index**	5.9%	5.1%	-9.4%	-2.7%	7.9%	6.7%	4.2%	11.7%
J212T	**FTSE/JSE Financials 15 Index**	4.1%	-6.1%	2.1%	23.3%	26.6%	3.3%	4.6%	9.0%
J403T	**FTSE/JSE SWIX Index**	2.8%	-4.3%	-5.0%	4.1%	12.2%	7.4%	5.2%	9.3%
J433T	**FTSE/JSE Capped SWIX Index**	2.8%	-4.3%	-4.2%	7.2%	16.7%	8.9%	5.4%	9.1%
J303T	**FTSE/JSE CAPI Index**	4.0%	-4.4%	-4.7%	6.1%	17.8%	11.5%	8.4%	10.7%
J253T	**FTSE/JSE SA Listed Property Index**	8.8%	-2.4%	-2.2%	9.7%	18.7%	-6.1%	-6.4%	2.7%
ALBI	**JSE All Bond Composite Index**	2.4%	0.3%	-0.4%	2.9%	8.3%	6.9%	8.0%	7.0%
STeFI	**STeFI Index**	0.4%	1.2%	2.2%	4.2%	4.1%	4.9%	5.9%	6.1%
	MSCI World Index in SA Rands	9.8%	3.9%	-2.4%	3.4%	9.6%	15.2%	14.0%	18.2%
	Rand/US Dollar Exchange Rate	1.7%	5.3%	7.7%	13.9%	-1.1%	5.1%	4.8%	7.3%
	Rand/Euro Exchange Rate	-0.8%	1.8%	-2.0%	-2.1%	-8.2%	2.3%	1.8%	5.3%
	Rand/Pound Exchange Rate	1.9%	2.1%	-2.3%	-0.3%	-4.8%	5.1%	3.1%	4.6%
	Headline CPI	1.1%	2.4%	4.2%	7.4%	6.1%	4.8%	4.7%	5.2%
	PPI	2.1%	5.8%	9.8%	16.2%	11.9%	8.0%	7.1%	6.4%