FOURword

Financial markets commentary

December 2023

27 FOUR

Record returns for bonds and equities as the pivot narrative takes centre stage

This month's update brings glad tidings as most major asset classes bounced back vigorously from the sell-off that took place between August and October. Markets were buoyed by positive inflation data and signs of a deepening global economic slowdown which cultivated the view that central banks will start cutting rates soon. Both headline and core consumer inflation softened at a pace faster than expected across major economies. Furthermore, the impact of monetary policy adjustments became evident in labour markets, with a slowdown in job creation and an increase in unemployment rates in the US. These dynamics saw bond yields softening encouraging investors to rotate back into equities, particularly interest sensitive sectors, that had fallen out of favour during the third quarter.

Consequently, global equities ended had a stellar month with the **MSCI World Index** delivering bumper returns of 9.21%. The upswing was primarily driven by robust performances in IT and consumer discretionary stocks, both recording significant double-digit gains of 13.57% and 10.74%, respectively. Financials, materials and industrials also performed well , with each sector delivering gains of over 8%. Overall, the rally was broad-based as all sectors recorded gains, except energy. Cyclical sectors outperformed defensive sectors by 6.8 percentage points. On style performance, growth and quality were outstanding, buoyed by the tech rally and recession concerns. Regionally, the European region outperformed with over 10% growth on the back of better-than-expected PMI numbers, indicating a slower contraction in Eurozone business activity for November.

The **MSCI Emerging Markets Index** mirrored global trend, gaining 7.86% in November. The primary driver was the Latam region, with a remarkable gain of 12.99%, propelled by the exceptional performance from Brazil (13.86%), influenced by the monetary policy easing. China gained 2.47% in dollar terms, with sentiment boosted by reports that the Chinese government included additional cash-strapped property firms on a list of eligible firms for various financial support. However, overall performance remains subdued.

The **Johannesburg All Share Index** also bounced back strongly delivering 8.55% in rand terms driven by industrials which gained 10.1%. Financials and resources were not far behind as they rose 8.48% and 6.4%, respectively. The resource sector took a breather from the previous months' poor performance on the back of strong performance across major sectors.

Bonds were perhaps the biggest beneficiary of the dynamics which took place in November as the **Bloomberg Global Aggregate Bond Index** notched one of its best months gaining 5.04% as yields. This move came as further evidence of a slowing economy strengthened calls for central banks to loosen their monetary policy. Additionally, less hawkish comments from central banks across the globe highlighted a cautious approach to future policy decisions, suggesting increases only if incoming information indicates insufficient progress in reducing inflation. The yields on the US 10-year, the UK's 10-year Gilt, and Germany's 10-year government bond ticked down to 4.3%, 4.2%, and 2.5% from 4.88%, 4.46% and 2.74% in October, respectively.

The domestic **All Share Bond Index (ALBI)** gained 4.73% in November with the 10-year government bond yield edging down to 9.96%, aligning with global peers. The South African Reserve Bank held its repo rate steady at 8.25% on November 23rd, in line with expectations, attempting to balance inflation concerns with the need for economic stability. Governor Lesetja Kganyago highlighted a cautious approach while remaining vigilant of multiple upside risks.

Inflation-linked bonds (CILI 4.83%) outperformed nominal bonds, indicating that upside risks to inflation remain elevated and signalling that rates will stay at elevated levels for an extended period. The latest CPI data revealed a significant increase in headline inflation to a five-month high of 5.9% in October, up from 5.4% in September. Although it still falls within the SARB's target range of 3% to 6%, it edged closer to the upper boundary.

The **Goldman Sachs Commodity Index** lost 3.67%, primarily driven by brent crude oil as investors braced for an OPEC+ meeting where the group will set production policy for 2024. Saudi Arabia advocated for other members to reduce production quotas to stabilize markets, but as of now, no resolution or deal has been reached. Originally scheduled for November 26, the meeting was postponed to November 30 due to a disagreement over output quotas involving African producers Nigeria and Angola. The US dollar depreciated 2.97% against a basket of other major currencies, with the greenback relinquishing its dominance amid dovish comments from central banks.

Our views for 2024

We won't dwell on this section extensively, as our views, which we have been communicating over the past six months, remain consistent. Our outlook on inflation remains optimistic, leaning towards a continuing disinflationary trend. This perspective is supported by several factors: a significant, rapid, and widespread tightening of monetary policy, the resolution of supply chain issues and backlogs, a shift of commodities into a cyclical bear market, a decline in global trade and manufacturing due to recessionary pressures, and noticeable macroeconomic challenges in China and Europe, both on the brink of or already experiencing economic contractions. This combination creates a reliable recipe for a disinflationary environment. However, we believe that a significant reduction in aggregate demand, necessary to bring inflation back below target levels, will require a weakening of economic activity and labour markets in most major economies. While there is strong evidence pointing in this direction, the extent of the slowdown remains uncertain. In our view, this should allow central banks to pause and assess incoming data. We anticipate that monetary conditions will remain restrictive for most of 2024, with only a slim chance of rate cuts.

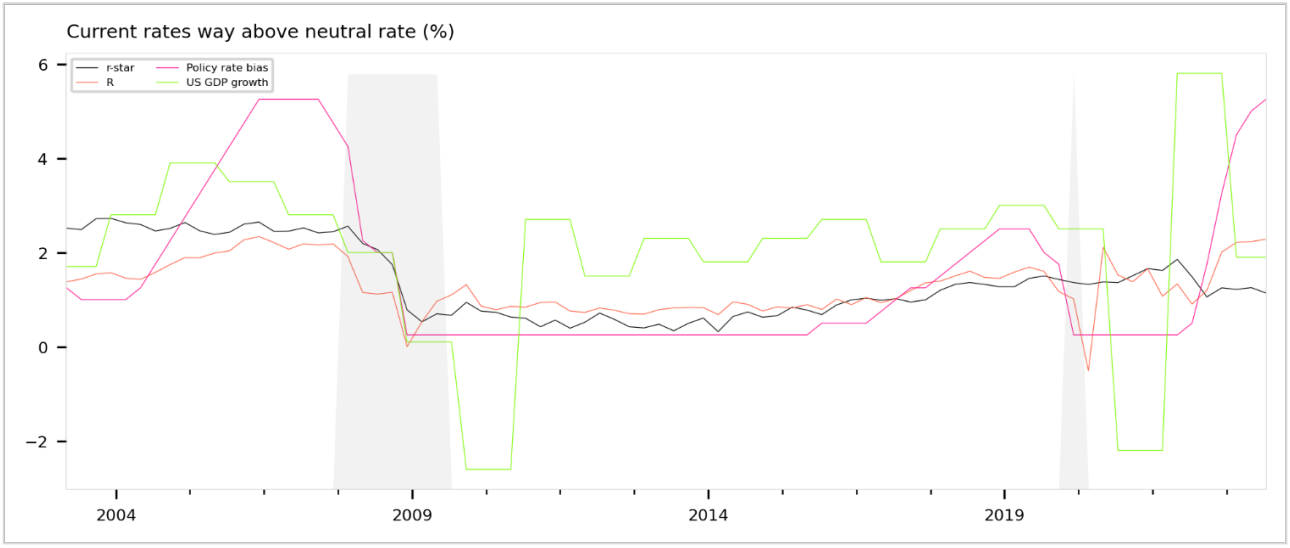
In light of these factors, we maintain a positive stance on bonds, a view we have held for an extended period. The recent resurgence in equities has made us more cautious about this asset class. Our analysis of investor behaviour reveals that markets are pricing in a perfect outcome regarding interest rates and economic growth, which, in our view, is not guaranteed. Therefore, we are becoming more discerning, giving careful consideration to valuations and sensitivity to economic growth.

At a high level, we see opportunities in South African equities, European equities, and Chinese equities, while exercising caution with respect to US equities. Nonetheless, we remain mindful of potential risks in 2024, with the following five being the primary concerns at the forefront of our minds.

Monetary policy overkill as central banks likely to err on the side of caution

Central banks are currently navigating a challenging path, something they haven't faced in quite some time. After receiving criticism for downplaying post-Covid-19 inflation (remember the transitory narrative) and responding cautiously, there is now a growing concern that they might overtighten and harm the economy. To combat high inflation, the Federal Reserve (Fed) raised interest rates by 500 basis points, bringing the target range to 5.25% - 5.5% in 2023, up from 0.25% - 0.50% in January 2022. Similarly, the Bank of England and European Central Banks have also increased their rates by 515 basis points and 400 basis points during this cycle. Nevertheless, despite these rate hikes, central bankers across the world have maintained a hawkish stance in their recent meetings.

The challenge lies in the fact that monetary policy operates with a time lag, and many of these central banks, which have not encountered such high inflation levels in their careers due to inflation being under control for most of the past decade, are essentially working in uncharted territory. This raises the genuine risk of excessive tightening in 2023 or 2025. The US Federal Reserve Bank acknowledged the dangers of over-tightening and has expressed its commitment to closely monitoring economic data to gauge the consequences of its actions. However, the central bank has also stressed its determination to bring inflation back to its 2% target, even if it means slowing down economic growth. Striking this delicate balance will be vital in determining whether the global economy will avoid a painful recession in 2024.

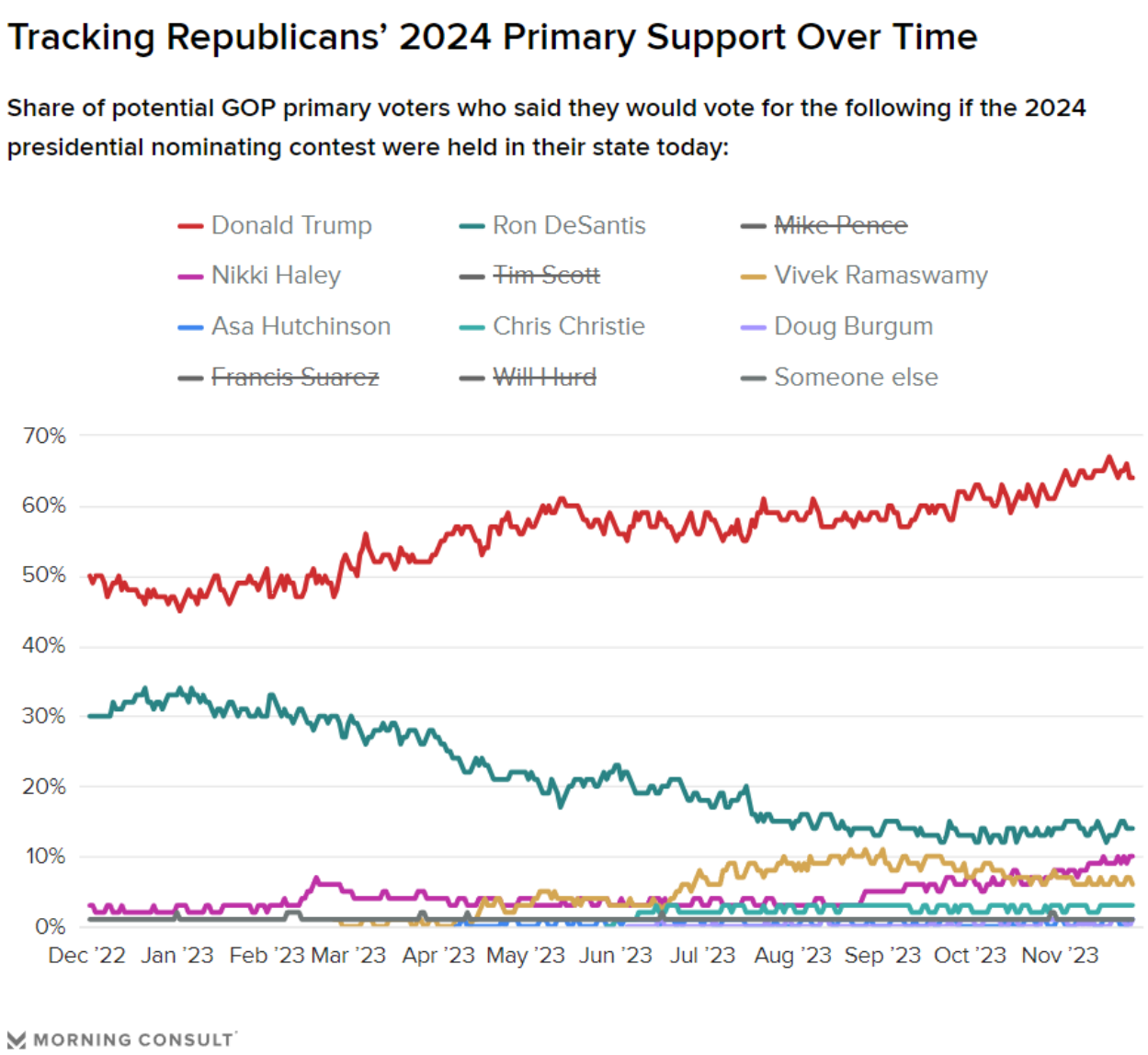


Source: Bloomberg

Donald trump re-election dilemma

Political risk in the United States has escalated significantly in recent years due to mounting polarization and increased brinkmanship within legislative bodies, prompting credit rating agencies to downgrade US debt from its previously perfect credit ratings. The situation may further deteriorate in 2024 due to an unprecedented election dilemma. For the first time in US history, a presidential aspirant, Donald Trump, carries a lengthy list of indictments. He currently faces four separate criminal cases encompassing a total of 91 felony counts across four different states. Additionally, there are ongoing civil fraud proceedings in Manhattan and a second defamation lawsuit brought by writer E. Jean Carroll, where Trump was previously found guilty of sexual assault and defamation, resulting in a $5 million judgment. Of particular significance among these legal challenges is the “classified documents case” in Florida, led by special counsel Jack Smith. This case, scheduled for May, involves a staggering 40 felony charges, with the most severe carrying a maximum penalty of 20 years in prison.

While the financial markets currently appear unperturbed by these developments, the United States may find itself in a precarious situation in 2024 if Donald Trump secures the Republican primary nomination or if he prevented from running for one reason or the other. A recent Morning Consult survey conducted in mid-November underscores Trump’s dominant position in the GOP primary race, with him polling at 66% among Republican primary voters and GOP-leaning independents, placing him well ahead of all his rivals combined, while Ron DeSantis trails at 13%. The potential for increased polarisation and even violence is significant, if Trump is prevented from running for any reason or if he is found guilty in a court of law. Nevertheless, there is still a possibility to mitigate this risk if Nikki Haley, another candidate with favorable ratings against Joe Biden, can mobilize her support base to challenge and defeat Donald Trump, or if Ron DeSantis emerges as the victor.



Coalition governments chaos going national

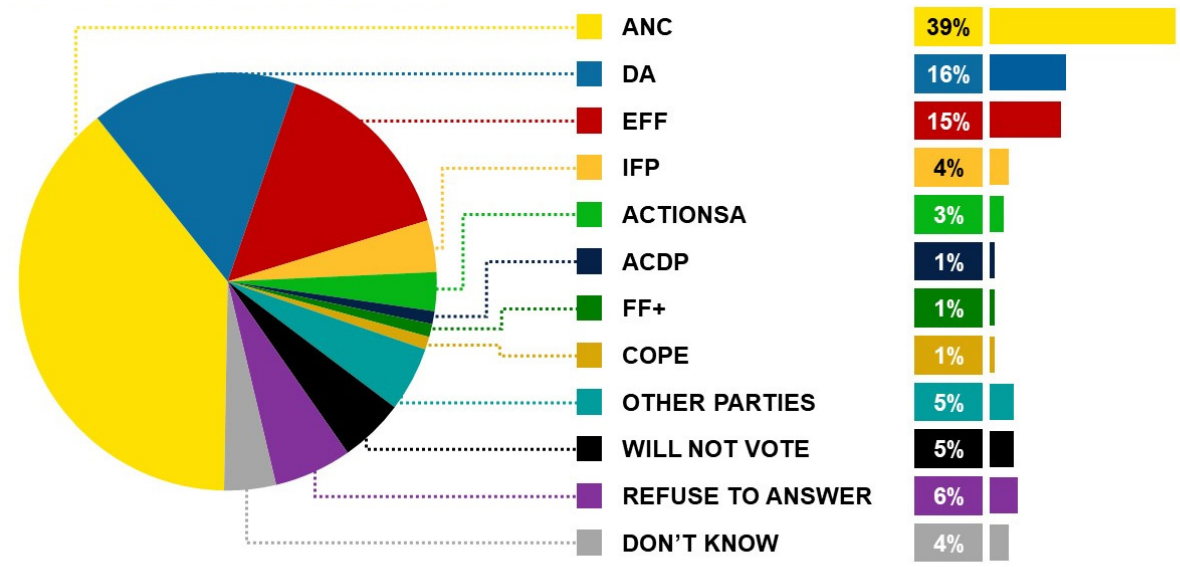
South Africa goes to the polls in landmark election in 2024. Many voters are eager to hold the ruling party, the African National Congress (ANC), accountable for what can be diplomatically termed as "missteps" over the past two decades. Key concerns include deteriorating infrastructure, the decline of state-owned enterprises, frequent power outages, water shortages, inadequate roads, sluggish economic growth, high unemployment, mismanagement of public funds, and pervasive corruption, all demanding immediate attention.

The prevailing consensus among South Africans and numerous political analysts is that the ANC is unlikely to secure a majority victory in the upcoming elections, raising the possibility of a unity government. The emergence of coalition governments gained prominence in South Africa's political landscape in 2016 when the ANC lost control over significant municipalities. Prior to that, the ANC had maintained uninterrupted dominance since 1994, following the National Party's rule from 1948 to 1994, resulting in a lack of recent experience with coalition governments.

While a coalition government can be a positive development for democracy and holding political leaders accountable, it may also lead to short-term turbulence. Coalition governments can function effectively, as seen in many European countries, Canada, Australia, and New Zealand. However, South Africa has encountered challenges with local government coalitions, as evidenced by incidents such as the upheaval in Nelson Mandela Bay, where the DA-led coalition unseated the ANC, and in Johannesburg, where the ANC did the same to the DA, hindering councils from effectively fulfilling their public responsibilities. The key distinction lies in their experience and well-established legal governance systems for managing coalition relationships, which South Africa currently lacks.

To address this, there is a need for a legal framework to govern coalition relationships. It is understood that Vice President Paul Mashatile has been working on such a framework, although gaining consensus among various political parties may prove challenging. However, this effort is crucial in mitigating the risks associated with the potential dysfunctionality of coalition governments at the national level, ensuring stable governance, and fostering a smoother transition should a coalition government emerge.

Party choices of South Africans who are registered to vote with the IEC



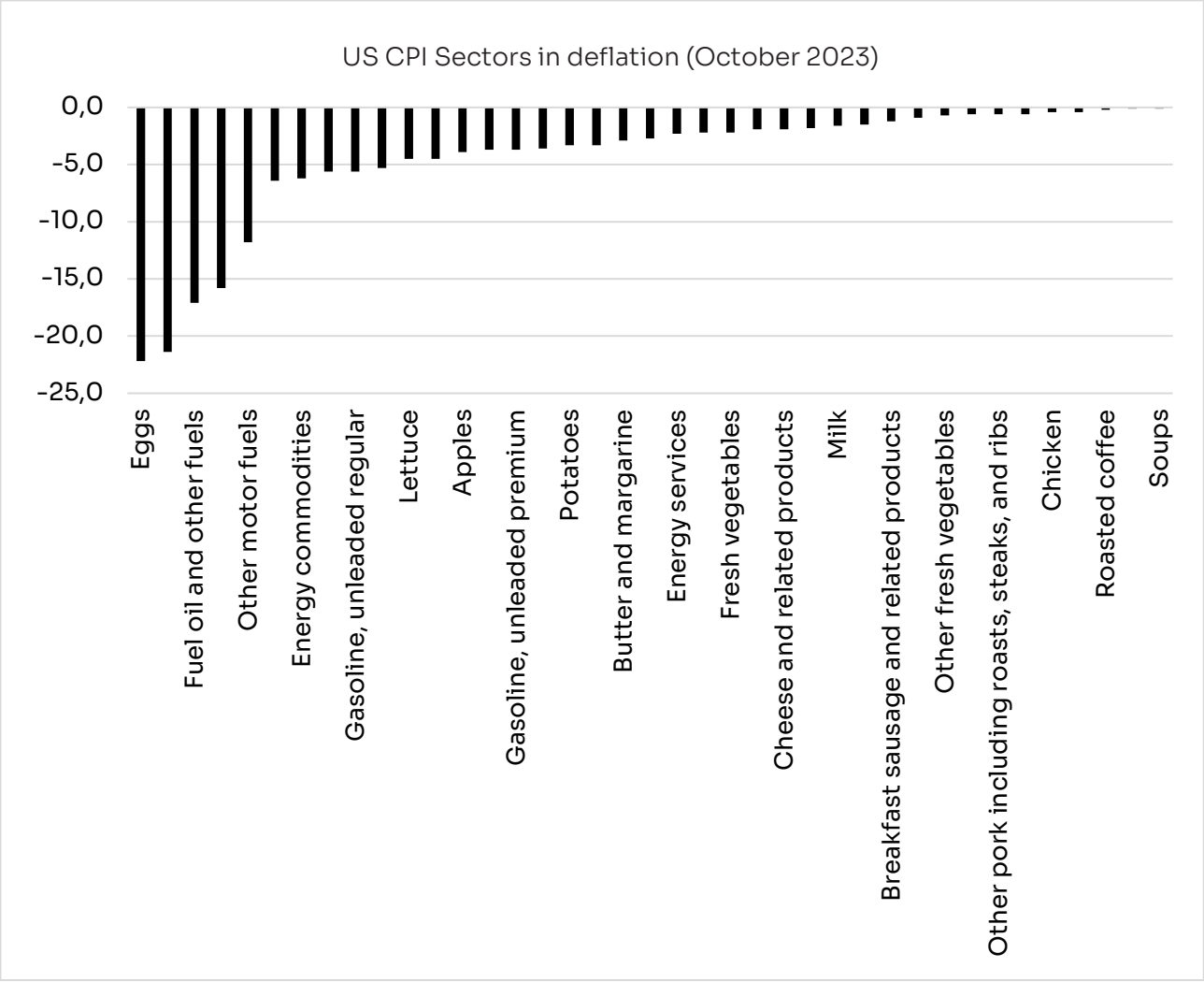
Possible political party choices in 2024 election (27 October 2023). Results from an Ipsos study

Deflation risk, not sticky inflation risk

After experiencing unprecedented levels of inflation in the post-Covid-19 era, many remain cautious about the inflation outlook, with some still concerned that inflation could persist stubbornly. This cautious approach is understandable and may be necessary to keep policymakers vigilant and prevent complacency. However, it is also influenced by recency bias, a well-known cognitive bias among investors.

Our perspective is more optimistic, leaning toward a disinflationary trend that we believe will continue. This trend is driven by several factors: a substantial, rapid, and widespread tightening of monetary policy, a resolution of supply chain issues and backlogs, a shift of commodities into a cyclical bear market, a dip in global trade and manufacturing due to recessionary pressures, and evident macroeconomic headwinds in China and Europe, which are on the verge of, or already experiencing, recessionary conditions. Additionally, some central banks, which will remain unnamed, appear to be on the brink of policy mistakes, either by excessively raising interest rates or insufficiently easing monetary policy. This combination creates a reliable recipe for at least disinflation.

The risk, therefore, leans somewhat towards the possibility of deflation, a scenario where inflation turns negative. In fact, when we examine the global landscape, we observe a significant increase in the number of countries experiencing "deflation," marked by negative year-on-year CPI readings. As of the latest data releases in October, just over 10% of the countries within our monitored basket are currently in a deflationary state. This represents a noteworthy shift from the 0% reading recorded in early 2022. It's worth noting that deflation can be as problematic, if not worse, than high inflation, as seen in the experiences of Japan and Europe, where they grappled with deflationary pressures for a considerable period.



Source: U.S. Bureau of Labor Statistics

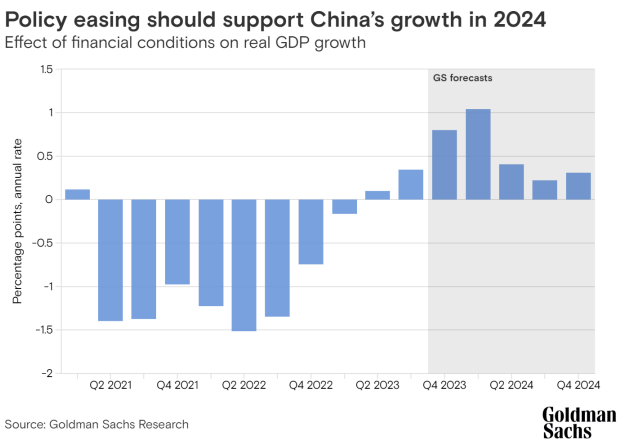
Write off China at your own peril

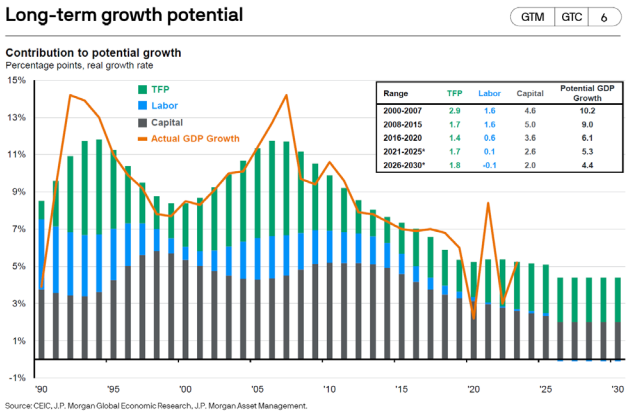
This is not a risk in the traditional sense. A stronger-than-expected growth performance from China would undoubtedly benefit global growth and could help mitigate the impact of slowdowns in the US and Europe. However, it is considered a risk because it's not factored into current market expectations.

The market's prevailing sentiment regarding China appears notably pessimistic, and this skepticism is not entirely unwarranted. Recent data reveals that China's economic growth momentum has remained rather stagnant. Nominal output growth, which considers the industrial and service sectors, has shown minimal change, and the property market, despite recent stabilisation efforts, remains subdued. The easing measures implemented in August have yet to substantially boost property sales, and export growth has declined further in October.

The International Monetary Fund (IMF) has revised upwards its projections for China's annual economic growth by 0.4% for the current year to 5.4% and the next to 4.6%. This positive outlook is also echoed by other U.S. investment banks. Strong third-quarter data and recent supportive policies from Beijing bolstered these expectations. However, achieving the projected growth in the following year remains challenging, the most significant risk factor lies in the property sector. Although sales have stabilised to some extent, they are still insufficient to support many real estate developers, including state-owned ones. If sales continue at the current pace and more developers encounter financial distress, it could further discourage potential homebuyers, leading to reduced sales and instability in the sector.

US Banks Raise China GDP Forecasts





However, the situation in China is not beyond repair. Beijing is likely to intervene significantly. A clear signal of this shift in policy came in October with the decision to expand the budget deficit by RMB1 trillion, bringing it to 3.8% of GDP for 2023. China has historically been cautious with fiscal policy, with deficits rarely exceeding 3% of GDP, except during the pandemic years of 2020 and 2021. Therefore, this year's decision to increase the deficit strongly indicates the central government's willingness to expand its balance sheet to support growth. Fiscal stimulus is preferred over interest rate cuts in China due to already low borrowing costs and concerns about a widening yield gap with the U.S. that could worsen the yuan's depreciation and capital outflows. The Chinese government is expected to approach interest rate cuts cautiously.

Policymakers are also increasing support for public-sector construction to offset the weakness in property demand. Beyond these traditional policy measures, there is potential for further evolution in the policy framework. The government may consider direct supply-side support, possibly by raising funds to ensure project completion or taking equity stakes in private-sector developers. While policymakers would prefer to stabilise the economy through increased fiscal spending rather than bailing out private-sector developers, the situation in the property market may necessitate a different approach.

In conclusion, writing off China as an investment opportunity may be premature, given the country's demonstrated willingness to adapt its policy framework to address economic challenges and stimulate growth.

Financial markets tables

As at 30 November 2023

SA indices (ZAR)	1 Month	3 Months	6 Months	YTD	1 Year	3 Years (Ann)	5 Years (Ann)
ALSI	8,55%	2,15%	2,55%	7,11%	4,69%	14,33%	12,37%
SWIX All Share	8,59%	2,15%	5,21%	5,18%	2,37%	11,10%	8,77%
Capped SWIX All Share	8,33%	2,03%	5,04%	4,83%	1,89%	13,62%	8,91%
Mid Caps	5,28%	0,78%	7,12%	1,66%	-1,32%	12,38%	6,37%
Small Caps	4,82%	0,40%	7,49%	4,88%	3,36%	23,67%	11,22%
Large Caps	9,09%	1,87%	1,30%	7,49%	5,06%	14,36%	13,25%
Resources	6,40%	4,27%	-8,97%	-11,81%	-14,89%	11,53%	17,27%
Industrials	10,10%	0,80%	2,24%	15,80%	15,48%	11,78%	11,97%
Financials	8,48%	2,14%	18,88%	13,38%	7,97%	19,47%	5,06%
SAPY	9,14%	1,57%	5,82%	0,22%	1,35%	16,17%	-1,84%
ALBI	4,73%	4,02%	11,03%	8,09%	8,76%	7,76%	8,06%
CILI	4,83%	2,69%	5,90%	4,84%	7,59%	8,84%	6,32%
STeFI	0,68%	2,07%	4,15%	7,31%	7,91%	5,54%	5,92%
Global indices (USD)							
MSCI World	9,21%	1,26%	7,97%	16,17%	11,13%	5,39%	8,17%
MSCI ACWI	9,07%	1,20%	7,43%	14,70%	10,06%	3,95%	7,18%
MSCI UK	6,17%	0,70%	2,42%	4,90%	4,37%	4,80%	0,95%
MSCI USA	9,21%	1,49%	9,67%	19,58%	12,39%	7,26%	10,65%
MSCI Europe ex-UK	10,75%	1,42%	5,09%	13,16%	13,25%	2,53%	5,41%
MSCI World Value	7,11%	0,19%	6,59%	3,26%	0,56%	5,14%	3,38%
MSCI World Growth	11,14%	2,23%	9,22%	30,22%	22,21%	4,95%	12,33%
MSCI Emerging Markets	7,86%	0,69%	2,98%	3,21%	1,52%	-6,43%	-0,15%
MSCI EM LatAm	12,99%	4,74%	12,42%	16,12%	10,67%	4,00%	-1,01%
Bloomberg Global Aggr. Bond Index	5,04%	0,76%	0,06%	1,65%	2,05%	-6,37%	-0,73%
Currencies and commodities (USD)							
GBPUSD	3,89%	-0,39%	1,45%	4,34%	4,69%	-1,79%	-0,20%
EURUSD	2,96%	0,41%	1,83%	1,73%	4,60%	-2,99%	-0,77%
USDZAR	1,10%	-0,09%	-4,41%	10,75%	9,54%	6,83%	6,34%
GBPZAR	5,01%	-0,50%	-3,06%	15,56%	14,65%	4,93%	6,14%
EURZAR	4,06%	0,30%	-2,67%	12,63%	14,55%	3,62%	5,52%
Gold Spot	USD	2,26%	4,95%	4,35%	11,92%	16,00%	4,74%
Brent Crude	-4,89%	-6,88%	11,38%	-5,88%	-7,03%	19,09%	6,46%
Goldman Sachs Commodity Index	-3,67%	-5,99%	5,22%	-8,90%	-10,52%	12,96%	6,45%