



## Market and economic outlook: January 2023

### Highlights

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#### Markets

- While global equity markets could be under pressure during the larger part of 2023 as they deal with the potential for recessions and the final phases of rate tightening, there could be some relief for equities towards the latter part of the year as markets start looking beyond the downward growth cycle and begin discounting an eventual Fed pivot to lower interest rates.
- Fundamentally, the anticipated combination of falling inflation and slowing economic growth (with a meaningful risk of recession) should be supportive of the United States (US) bond market in 2023. This could re-establish the hedging benefits of having government bonds in a global diversified portfolio, particularly during potential equity drawdown periods amid a cyclical slowdown or recession. The significant runup in bond yields in 2022 has once again made fixed income a viable income-providing alternative to equities and made US government bonds look cheap versus US equities.
- Although global property fundamentals remain solid and the asset class looks cheap against equities, its expensiveness against fixed-income assets erodes its relative attractiveness.
- South African (SA) equities have an attractive valuation underpin, both within the global universe and against its history. This should stand it in good stead during potential global equity drawdowns, but particularly during subsequent recoveries when global risk appetite rises. Even more so, as SA is the fifth most underowned market within global emerging market (GEM) equity funds.
- SA real bond yields are attractive against their history, as well as relative to those in global markets, with part of the high real yield differential due to a fiscal and country risk premium. We expect falling inflation in the coming year to become less supportive of inflation-linked bonds (ILBs). The prospective SA real cash yield has been rising from a low level in line with policy rate increases and is now only slightly below its historical average.
- Although SA listed property operational metrics are improving, they remain worse than in the pre-COVID era. The potential for meaningful listed property return upside from undervalued levels needs to be weighed against some remaining negative fundamental factors.

#### Economics

- The globe is facing higher levels of geo-economic fragmentation, reduced liquidity, a lower growth pattern in China, increased global conflict and higher inequality.
- Although an over-tightening in monetary policy raises the risk of negative growth outcomes sooner, the risk of under-tightening is seen to pose a bigger threat. Unhinged inflation expectations could force central banks to tighten policy even more, over a longer period, resulting in a more damaging hit to growth and jobs.

- A further easing in supply-chain disruptions, favourable base effects in food and fuel and demand destruction are expected to drive inflation lower in 2023. A return to central bank targets could nonetheless take time given stickier services and wage inflation.
- In our view, central banks need to have clear sight of a sustained deceleration in underlying inflation and a reversal in tight labour market conditions for interest rate cuts to be considered. Market-implied policy rates point to a peak in the US federal (Fed) funds rate in the first half of next year. Market participants are pricing in a cut before the end of 2023, after an expected pause.
- A faster relaxation in COVID-19 regulations in China, a warmer winter in Europe that prevents energy rationing or stronger real wage growth for the US consumer can lift our base case view on global growth.
- Stickier inflation leading to additional interest rate tightening (relative to the baseline), a colder European winter that enforces more energy rationing, a bumpier path to unwinding China's zero-COVID strategy, renewed Chinese property sector woes or an accelerated decoupling between the US and China could leave global growth at a mere 0.5% in 2023.
- Lower growth in SA's main trading partners will reduce demand for SA's exports, while slow reform in energy and logistics as well as mounting consumer headwinds will cap growth in domestic demand. Question marks over SA's political outlook cast a dark shadow over investment and growth prospects.
- The SA Reserve Bank (SARB) is likely to hike further in the first quarter of 2023 to arrest the spread of broad-based inflation pressures.
- A potential greylisting and a consequent exiting of a greylisted status will depend on perceived action to address the Financial Action Task Force's (FATF) concerns.

## A turbulent year for investors

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Fund managers were left with little place to hide in financial markets given losses experienced in equity markets and a torrid year for bonds, which faced a surge in inflation and an aggressive response from central banks. Commodities (soft commodities, in particular) were among the best performing asset classes given supply chain blockages exacerbated by the Russian-Ukrainian conflict. Meanwhile, after soaring to record highs during the pandemic, Bitcoin sank to the bottom of the performance table last year as the collapse of the cryptocurrency exchange FTX shook the entire crypto world. A number of crypto exchanges and lenders filed for bankruptcy or paused customer withdrawals in 2022.

Despite geopolitical turbulence and elevated uncertainty, Wall Street's fear gauge (the CBOE Volatility Index or VIX) topped out at 36 points in early March 2022 and retreated to below 22 points by the end of the year. In contrast, the Merrill Lynch Option Volatility Estimate (MOVE), which captures a yield curve-weighted index of the normalised implied volatility on one-month Treasury options, peaked at 160

points in October, before retracing to 113 points by the end of last year, which was still 34 points higher than the start of 2022.

The Russian invasion of Ukraine exacerbated supply-chain disruptions and sent the prices of soft commodities soaring in 2022. The Bloomberg Commodity Price Index, which also includes hard commodities, increased by 16.1% in 2022, following a 27.1% rise in 2021. The dollar price of gold ended the year largely unchanged (a return of negative 0.3%) at US\$1824/oz with sharp rises in the US dollar and Treasury yields limiting gains during the year, while the dollar price of platinum and crude oil rose by 10.9% and 10.5%, respectively, to end the year at US\$1079/oz and US\$86/bbl.

Global equities finished last year 18.4% weaker (see chart 1), erasing gains of a similar magnitude the year before. This was the weakest result since 2008 (when global equities tanked 42.2%) and the third worst year since 1987. Developed and EM equities performed equally as poorly over the year. The MSCI Developed

Market (DM) Index fell 18.1% in 2022, after gaining an impressive 21.8% in 2021. Meanwhile, the MSCI EM Index extended its losses by a further 20% after dipping by 2.5% in 2021.

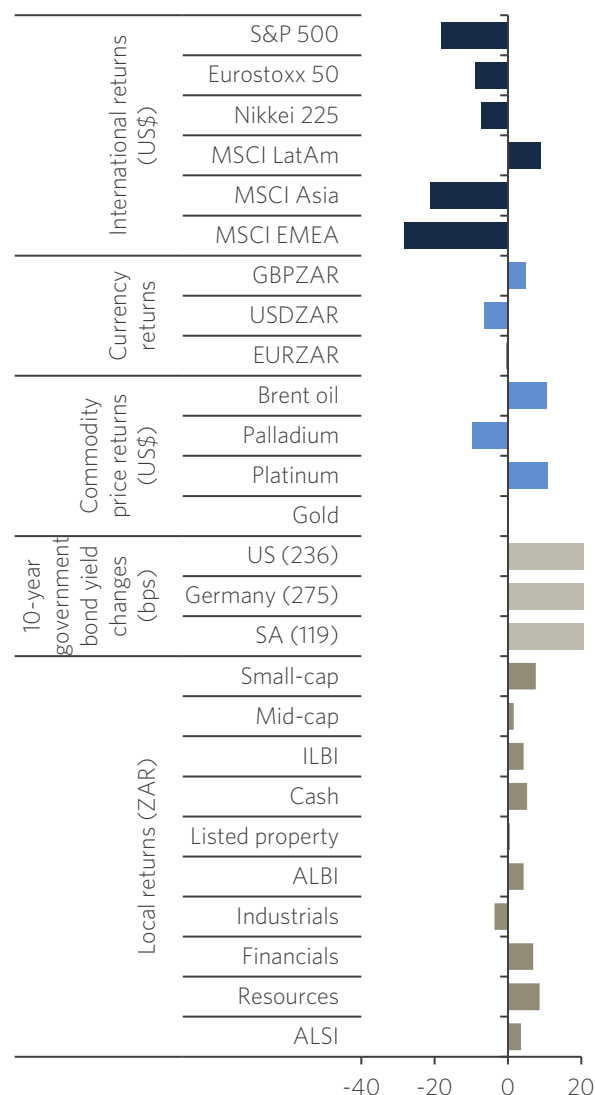
Within the DM composite, US equities were hit the hardest. The S&P 500 Index fell 18.1% (relative to a 37% drop in 2008) and lost US\$8.22 trillion after a banner year for equities in 2021. The Fed's resolve to quell high inflation led to one of the most aggressive interest rate tightening cycles in decades, dampening the outcome for equities. Growth and technology shares were particularly battered given sticky inflation, steep interest rate hikes and downbeat sentiment, while defensive sectors outperformed amid growing recessionary fears.

Returns on the Eurostoxx 50 Index have been in negative territory six times since 2007. The index lost 8.8% in 2022, after surging 24% the year before. Returns were notably more negative in 2008, 2011 and 2018. Across in Japan, the Nikkei 225 Index dipped for the fifth time since 2007. The index shed 7.3% in 2022, following a 6.7% uptick in 2021.

Weakness in the MSCI EM Index was predominantly driven by a sharp fall in equities in the Europe, Middle East and Africa (EMEA) and Asian regions, while equity markets in Latin America managed a healthy gain of 8.9%, making up for an 8.1% dip in 2021. The MSCI EMEA Index fell sharply by 28.3% after rising 18% in 2021. The MSCI Asia Index reported losses for a second consecutive year and plunged 21.1% in 2022.

Even though bonds usually act as a shock absorber in portfolios when equities plunge, the global bond market suffered a significant meltdown last year. More-aggressive-than-expected interest rate hikes and decades-high inflation pressured most bond asset classes, with 2022 registering as the worst year for the Barclay's Global Aggregate Bond Index, since its inception. The yield on the US 10-year government bond rose by an additional 236 points in 2022, following an increase of nearly 60 points in 2021, while the German 10-year government bond yield increased by nearly 275 basis points last year and 314 basis points since the end of 2020.

Chart 1: Annual asset class returns (%)



Source: Iress, Momentum Investments

10-year government bond yield changes indicated in brackets (truncated in chart)

Alongside rising risk aversion, the JP Morgan EM Bond Index (EMBI) spread experienced an uptick of 44 points and ended 2022 at 374 points. Hungary and Romania experienced the largest quarterly widening in credit default swap (CDS) spreads of 342 points and 257 points, respectively, in 2022.

The local equity market outperformed its global counterparts and gained 3.6% in 2022, following a robust increase of 29.2% the year before. Energy, tobacco, banks, metals/mining and food producers were the top performers last year, while

pharmaceuticals, construction and telecommunications brought up the rear in the local equity market. Gains were driven by the FTSE/JSE Resources Index which closed the year 8.6% in the black. The FTSE/JSE Financials Index jumped 6.9% in the same period, while returns on the FTSE/JSE Industrials Index disappointed at negative 3.7%.

The FTSE/JSE Mid-cap index ended the year 1.6% firmer while small-cap equities powered ahead at 7.6%. In SA's fixed income markets, the 10-year government bond yield sold off 119 basis points. The JSE Assa All Bond Index returned 4.3% for the year, while the JSE Assa Government ILB Index gained by a similar margin. The FTSE/JSE SA Listed Property Index eked out a 0.5% return for 2022 after recovering by 36.9% a year earlier.

EM currencies generally weakened against a firmer dollar in 2022, despite the latter losing steam towards the end of the year on investor expectations for a lower peak in US interest rates amid concerns over an impending recession. The Russian rouble outperformed by nearly 81%, followed by a 34% recovery in the Argentine peso in 2022. Meanwhile, the South Korean won and Hungarian forint posted the weakest returns of the EM peers at around negative 11% against the US dollar in 2022. The rand depreciated by 6.4% against the US dollar and 0.5% against the euro but strengthened by 4.7% against the British pound. A struggling UK economy and a continuation of the energy crisis have continued to weigh on the pound.

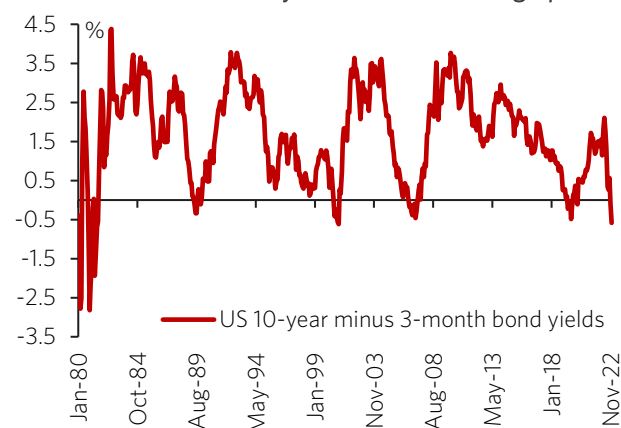
Despite reaching 380 points in July 2022, SA's five-year CDS spread widened only marginally by 23 points for the full year and ended 2022 at 244 points.

## Interplay between inflation, rates and growth to determine global asset class returns in 2023

In the absence of further energy or supply chain shocks, it currently seems likely that global inflation should fall in 2023, led by the US. Not only will a very high 2022 base assist the year/year comparisons in 2023 (particularly for headline inflation), but disinflationary trends should be further supported by an already evident improvement in supply bottlenecks, the erosion of corporate pricing power by high inventory levels and a slowdown in cyclical demand.

While a slowdown in global economic activity in 2023 seems almost inevitable in reaction to previous policy tightening and the erosion of real spending power, the magnitude of the growth slowdown remains uncertain. A mild slowdown (or so-called soft landing) is certainly still possible, but more indicators are pointing to the increased probability of a global recession this year. Among these, inverted yield curves, as a reflection of tight monetary policies, have increasingly become the norm in many DMs. In the US, the recent inversion of the three-month/10-year part of the yield curve has historically been an infallible predictor of a US recession within the subsequent 12 months (see chart 2).

Chart 2: US recessionary indicators are lining up



Source: Iress, Momentum Investments

Cyclical slowdowns or recessions have not been good for growth assets like equities historically. MRB Research shows that recessionary periods since 1970 have been particularly harsh for global equities, with drawdowns during recessions roughly three times larger and lasting around four times longer than those in non-recessionary slowdowns (see table 1). Part of the explanation for the exaggerated poor equity performance during recessions is the outright contraction in corporate profits normally associated with recessionary periods.

**Table 1: Peak-to-trough declines during historical global equity corrections**

	Mean % decline	Median % decline	Days decline
All corrections	-19%	-12%	220
Non-recessions	-13%	-11%	101
Recessions	-36%	-33%	418

Source: MRB

Should a recession come to fruition in 2023, current US consensus earnings numbers that still anticipate mid-single-digit growth rates for the year will have to be cut well into negative growth territory. Furthermore, research from Bank of America reveals that US equity volatility normally rises during recession years and that the US equity market never bottoms before a recession starts (see table 2). These factors point to the possibility of more downside for US equities in the run up to a potential recession in 2023, unless a recession can be avoided.

**Table 2: US equities never bottom before a recession starts**

		Days before (-) / after (+) start of recession		Days before (-) / after (+) end of recession
Peak date	Trough date	S&P 500 peak	S&P 500 trough	S&P 500 trough
5 Jan 1953	14 Sep 1953	-207	45	-259
2 Aug 1956	22 Oct 1957	-394	52	-190
3 Aug 1959	25 Oct 1960	-271	178	-126
29 Nov 1968	26 May 1970	-397	146	-188
11 Jan 1973	3 Oct 1974	-323	307	-179
13 Feb 1980	27 Mar 1980	13	56	-126
28 Nov 1980	12 Aug 1982	-245	377	-110
16 Jul 1990	11 Oct 1990	-15	72	-171
24 Mar 2000	9 Oct 2002	-372	557	313
9 Oct 2007	9 Mar 2009	-83	434	-113
27 Dec 2019	23 Mar 2020	-64	23	-38
	Median	-214	204	-108
	Average	-245	146	-126

Source: Bank of America

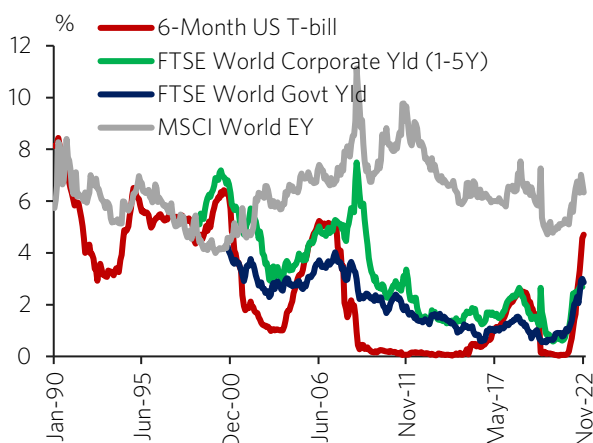
While global equity markets could be under pressure during the bulk of this year as they deal with the final phases of rate tightening and the potential for economic recessions, there could be some relief for equities towards the latter part of the year as markets start looking beyond the downward growth cycle and begin discounting an eventual Fed pivot to lower interest rates. This could support equity valuations enough to negate the negative impact of ongoing downward earnings revisions at the time, igniting an equity market recovery by then.

Fundamentally, the anticipated combination of falling inflation and slowing economic growth (with a meaningful risk of recession) should be supportive of the US bond market this year. Research by Morgan Stanley shows that during downturn phases of the US business cycle, US bonds provide better-than-average returns, whereas US equities provide significantly worse-than-average returns. As inflation subsides, this could re-establish the hedging benefits of having government bonds in a global diversified portfolio in 2023, particularly against the backdrop of drawdown risk for equities during downturn/recession periods.

For a long time since the global financial crisis (GFC), fixed-income yields remained so low that investors seeking income for their portfolios had no option but to favour equities, where they could at least get more meaningful income from dividends. This became known as the TINA era, that is there is no alternative (to equities). However, with fixed-income yields shooting up in 2022 to narrow the gap with equity yields (see chart 3), TINA has now evolved to TANYA (there are nominal yield alternatives) and TARA (there are real alternatives).



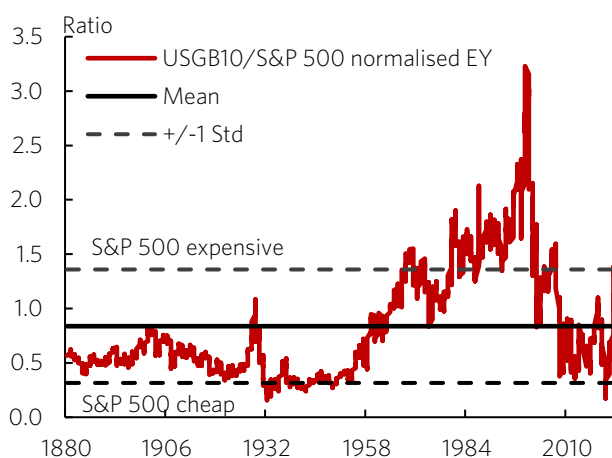
**Chart 3: Fixed-income yields have narrowed the gap with equity yields**



Source: Morgan Stanley

The significant runup in bond yields last year has also now made US government bonds look cheap versus US equities. On a normalised earnings yield gap basis (using earnings over the past decade), US equities are currently around one standard deviation expensive versus bonds on long-term averages (see chart 4). At the current through-the-cycle earnings yield, US 10-year bond yields would have to fall to around 2.4% to erase the equity valuation premium. Conversely, at current bond yields, US equities would have to fall by around 35% to close the valuation gap.

**Chart 4: Relative US equity/bond valuations**



Source: Iress, Momentum Investments

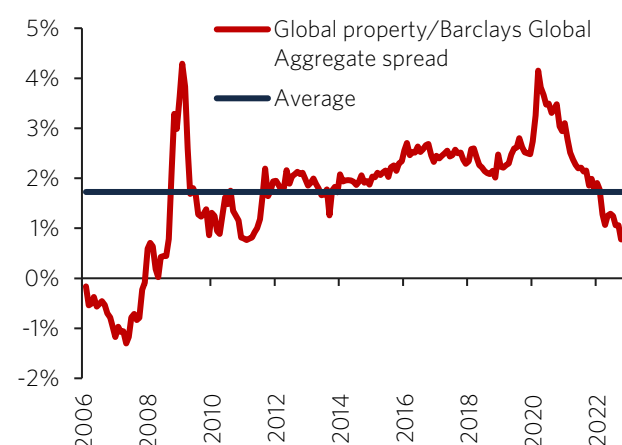
Global property fundamentals remain solid, with strong US rental growth across sectors outside Office, US vacancy rates outside Office around historical lows and US real estate investment trust (REIT) balance sheets

strengthening since the global financial crisis (GFC). Not only has REIT sensitivity to interest rates declined since the GFC with the interest cover ratio halving, but REITs have also locked in low interest rates into the future with the average debt maturity profile now more than seven years, from five years in the GFC. Added attractions are that US property historically provided inflation protection to portfolios, outperforming equities during higher inflation periods, while also providing diversification benefits to a multi-asset portfolio.

Global property currently looks cheap against global equities, with an above-average yield spread. However, the global property yield is currently expensive versus fixed-income assets (nominal and real US yields, as well as global investment-grade bonds), with yield spreads below their historical averages (see chart 5), hence eroding the relative attractiveness of the asset class.

For SA investors, our expectation for some rand appreciation as global risk appetite improves later in 2023, would erode the local currency returns from global assets. Together with the more attractive valuations available from SA assets that provide a high margin of safety, we prefer SA asset classes over global assets in 2023.

**Chart 5: Global property expensive versus global investment grade bonds**

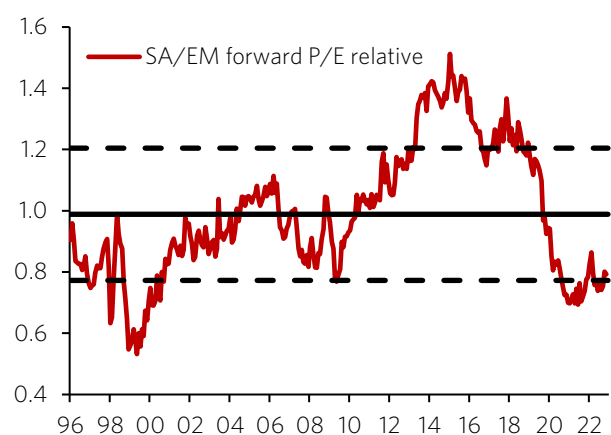


Source: Bloomberg, Momentum Investments

## Underowned and undervalued SA equity market has rerating potential

SA equities have an attractive valuation underpin, both within the global universe and against its history. This should stand it in good stead during potential global equity drawdowns, but particularly during subsequent recoveries when global risk appetite rises. SA equity valuations remain cheap against EM (and even more so against DM), with SA a superior dividend payer within EM and at a large forward P/E discount to EM (see chart 6). Research by SBG Securities highlights that apart from insurance, real estate, banks and capital goods, all MSCI SA sectors are trading at a discount to MSCI EM currently.

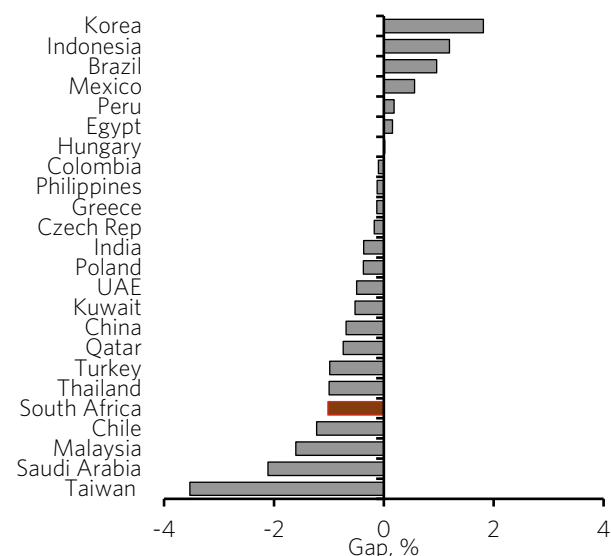
Chart 6: SA forward P/E relative to EM



Source: SBG Securities

Russia's exclusion from EM indices and investor worries about China's investability within EM due to regulatory overreach should benefit the other constituents of EM equity benchmarks. This should be particularly true for SA, which is the fifth most underowned market within GEM equity funds (see chart 7) and as such should have meaningful rerating potential from current cheap valuations when global risk appetite improves.

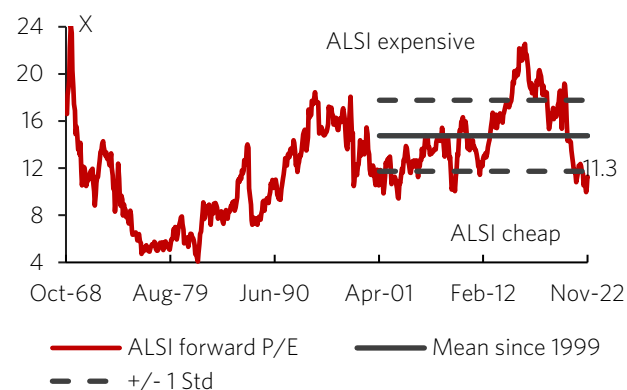
Chart 7: GEM funds' % allocations to EM countries versus benchmark



Source: SBG Securities

Even assuming a conservative 6% earnings growth in the next year, the SA equity market is now more than one standard deviation cheap on a forward P/E basis against the average since 1999 (see chart 8). In our view, a lot of bad news is currently priced into SA equities, enhancing the future return potential from current levels.

Chart 8: ALSI forward P/E



Source: Iress, Momentum Investments

## SA bond yields are attractive in real terms

With global inflation still at very high levels, the real government bond yields available in the developed world remain in significantly negative territory. Although there are inflation outliers like Turkey within EM, in general, inflation rates in the emerging world have lagged those in DM. As such, EM real bond yields based on current inflation rates remain positive in most EM countries, with SA's real yields among the highest (see table 3).

**Table 3: Real ex-post 10-year government bond yields**

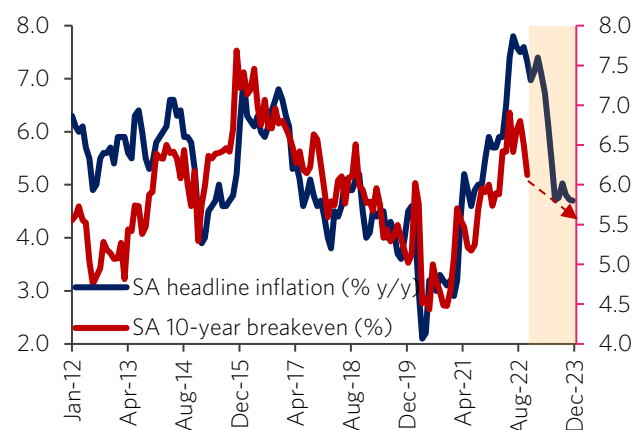
<i>DM</i>	
Japan	-3.5%
US	-4.2%
UK	-8.0%
Europe	-8.2%
<i>EM</i>	
Brazil	6.4%
South Africa	3.9%
Mexico	0.6%
Russia	-2.5%
Turkey	-75.0%

Source: Iress, Momentum Investments

Not only are SA real bond yields currently attractive versus DM and EM yields, but SA's real yield premiums against DM are also high against historical averages. Furthermore, SA's prospective real yield is also more than one-half of a standard deviation higher than its historical average. We argue that SA's high real bond yields already discount high fiscal and country risk premiums.

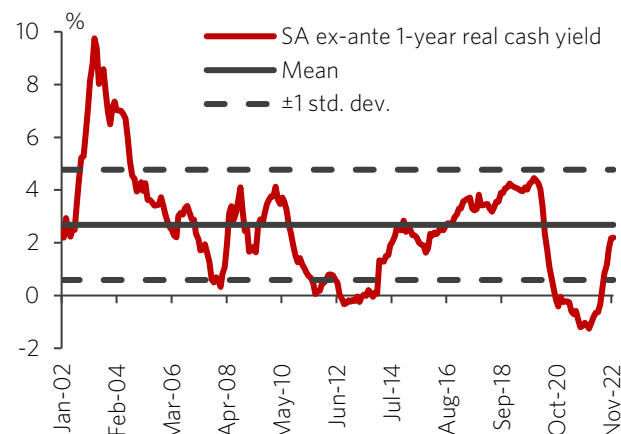
In the ILB space, we expect some breakeven tightening in line with falling inflation in the coming year (see chart 9). As such, monthly inflation accruals are likely to remain low until the second quarter of this year, which should become less supportive for ILBs. The prospective SA real cash yield has been rising from a low level in line with policy rate increases and is now only slightly below its historical average (see chart 10).

**Chart 9: Breakeven tightening expected in line with falling inflation in the coming year**



Source: IRESS, Momentum Investments

**Chart 10: Prospective SA real cash yield**

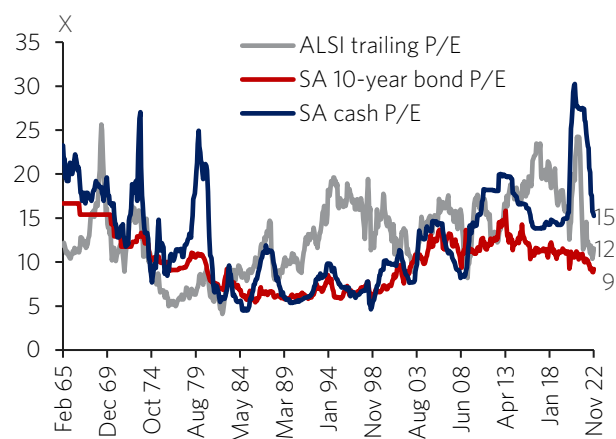


Source: Iress, Momentum Investments

Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013 (see chart 11). Aggressive COVID-related SARB interest rate cuts have made cash the most expensive asset class since 2020, while sharp profit upgrades in 2021 have pushed SA equity valuations sharply down.



Chart 11: SA asset class valuations

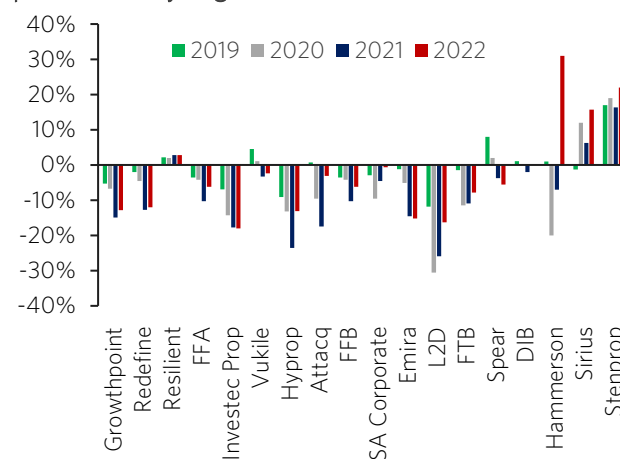


Source: Iress, Momentum Investments

## Listed property operational metrics improving, but still worse than pre-COVID

Earnings recovery in the SA listed property sector is supported by continued operational improvement outside the office sub-sector, with vacancy rates, rental growth and rental reversions generally improving. But metrics are still worse than pre-COVID and reversions are still predominantly negative (see chart 12), which keep net operating income growth anaemic. At least it seems as if property values have stabilised outside the office sector, with some companies even experiencing rising valuations. From a portfolio construction perspective, the potential for meaningful listed property return upside from undervalued levels needs to be weighed against some remaining negative fundamental factors.

Chart 12: Rental reversions improving, but still predominantly negative

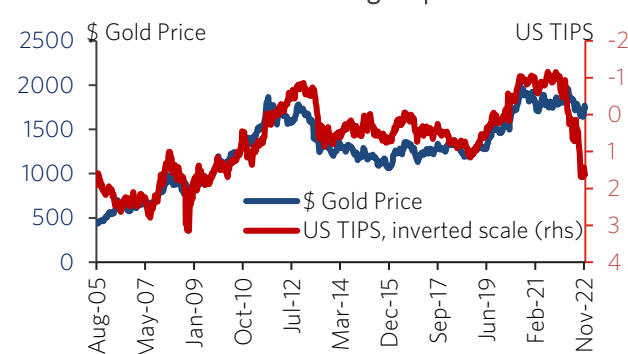


Source: Company reports, Momentum Investments

## Gold price currently too high based on US real rates

With the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset, it is unsurprising that US real interest rates have been the dominant determinant for the US dollar gold price in the last two decades (see chart 13). A bigger surprise is that movements in the US dollar do not provide additional explanatory power for the behaviour of the dollar gold price.

Chart 13: US real rates and the gold price



Source: Iress, Momentum Investments

Based on the current level of US real interest rates, the predicted value of the dollar gold price is almost 50% below the current actual spot level. Tactically, gold is thus not an attractive asset class right now. However, we maintain that there is always a strategic rationale for

gold as a portfolio risk diversifier due to its safe-haven characteristics during risk-off global bouts, as well as its limited correlation with other asset classes in a portfolio.

## A world with more fragility

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Despite the new Omicron variant of COVID-19 knocking at the door to the entrance of 2022, people around the world were largely expecting better global growth and lower volatility in financial markets. Many have, unfortunately, been negatively surprised at the way last year unfolded. The world economy has faced a spate of ill-fated events, starting with Russia's war of aggression in Ukraine, a crippling energy crisis, higher inflation, tighter global financial conditions and strict lockdown measures in China.

As conflict continues in Ukraine, Russia has refocused its war efforts to target civilian infrastructure. Although the Kremlin is beginning to feel pressure to show results in Ukraine after facing setbacks on the battlefield, financial markets deem the use of nuclear weapons as low. Nevertheless, in our view, this risk could rise should Russia face defeat in Ukraine.

Aside from the war in Ukraine, the global incidence of unrest has risen. But this could get worse before it gets better. In September last year, Verisk Maplecroft highlighted that from the 132 countries analysed, 62 were expected to see the risk of social unrest increasing in the following two quarters. This is unsurprising given the effect of sharply higher food and fuel costs on inequality, particularly across EMs where consumers typically spend a larger share of their wallet on such items.

The World Bank warns that we have shifted from an era of relative predictability to a world with more fragility. Previously, international co-operation was premised on a rules-based framework, resulting in lower inflation, lower interest rates and lower volatility. Greater uncertainty, higher volatility, geopolitical strife and more frequent climate-related disasters are nevertheless gripping the global economy and darkening the outlook for growth.

Wellington Management argues that under this new regime, central banks will, at times, struggle to find an appropriate balance between taming inflation and supporting growth. Consequently, we are likely to experience more frequent moves from one economic phase to another.

More regular economic and political shocks are likely to throw economies off course more easily unless a greater level of resilience is instilled at a macroeconomic level. While random and exogenous events can overshadow the impact of fundamental factors, a focus on long-term structural trends can help to reduce reliance on timing shorter-term cycles and shorter-term economic and market forecasts, which are likely to span a wider range going forward.

The impact of the war in Ukraine, persistent inflation, soaring cost of living pressures, an acute energy crisis in Europe and an unexpected slowdown in China have impaired growth. With policy homogeneity having increased across the globe this year, investors are concerned that a simultaneous tightening in monetary policy will compound growth woes. Although we have experienced the fastest pace of interest rate hikes in decades, the World Bank shows that interest rates, particularly in inflation-adjusted (real) terms remain negative in aggregate and are significantly lower at this point relative to prior global recessions in post-war history.

With rising price pressures posing the most immediate threat to real disposable incomes, central banks have narrowed their focus on restoring price stability, even as fears mount over slowing global growth. While the International Monetary Fund (IMF) acknowledges the potential risks associated with an over-tightening in monetary policy, to the extent that policymakers are forced to reverse hikes sooner than anticipated in a

perceived policy error, it warns that the risk of under-tightening is a larger concern. Allowing inflation to run hotter for longer could derail inflation expectations and embed persistent price pressures. Central bank credibility would not only be negatively affected, but a deeper cost-of-living crisis would force central banks to tighten by more, at a later date, compounding negative growth and employment outcomes.

Prospects for growth this year have dimmed considerably. At the start of 2022, the consensus expected DMs to grow at 2.4% this year. However, this projection has faded to 0.5%. Similarly, a year ago, financial markets were looking forward to growth of 4.8% in EMs for this year. But these forecasts have since slipped to below 4%. This is in spite of a better expected outcome for China in 2023, particularly in light of recent measures to lift stringent lockdown regulations.

Although these revisions appear large, the World Bank notes that market revisions to growth in the year preceding a recession were worse during the GFC and the COVID-19 pandemic. In the case of the former episode, expected global growth experienced a downgrade of around 5.5% in the year running up to the recession. Meanwhile, downward revisions to expected global growth in the year preceding the pandemic amounted to more than 7%. In this context, the adjustment to growth forecasts this time around does not appear as severe. As such, we see the risk of a global downturn as being higher than an outright global recession. A contraction in real gross domestic product (GDP) per capita during a typical recession impacts standards of living and has significant socio-economic repercussions, making the distinction between a downturn and a recession important.

The risk of a global recession cannot, however, be definitively ruled out at this stage. With the IMF predicting that growth in more than a third of economies worldwide will contract either in 2022 or 2023 (up from 5% at the start of 2022), the World Bank warns that only a small shock is required to knock the global economy into a deeper slump.

Indicators such as global growth, manufacturing new export orders, the global purchasing managers' index and global equity prices have followed the same path as prior global recessions. Consumer sentiment has however fallen more sharply relative to past cycles on the back of a collapse in growth in real disposable income of negative 3.5% for the global economy, due to rising living costs.

Depressed sentiment has raised recessionary risks. At the end of 2021, the Bloomberg consensus forecasted the recession risk for the US economy in the next year at 15%. However, this probability rocketed to 65% a year later. Similarly, the consensus pitched the probability of a recession in the United Kingdom (UK) and Germany at around 20% at the end of 2021, but these forecasts have since jumped to 90%.

The outcome for the US economy plays an important role in determining the recession probability for the global economy. The World Bank notes that on an unconditional basis, the probability of a global downturn or recession is between 10% and 15%. However, if the US economy slips into recession, the risks of a global recession or downturn are higher at around 70% and 85%, respectively.

In our view, solid fundamentals could prevent a deep and protracted recession in the US economy despite our forecast of a marginally negative growth rate for this year of negative 0.1%. Firstly, household wealth (still close to 780% of disposable income) and savings remain supportive of household spending. Secondly, unemployment rates remain close to multi-decade lows with the US labour force participation rate close to 80% if the age group older than 54 years is excluded. Thirdly, banks' capital buffers are higher than in the period leading up to the GFC, leaving the US economy with a higher level of financial stability this time around. Fourthly, central banks have acquired a higher level of credibility since the 1970s when the world hit a stagflationary bump in the road.

And finally, even though the US housing market is showing signs of distress, the dip experienced so far has not been as severe as that during the GFC.

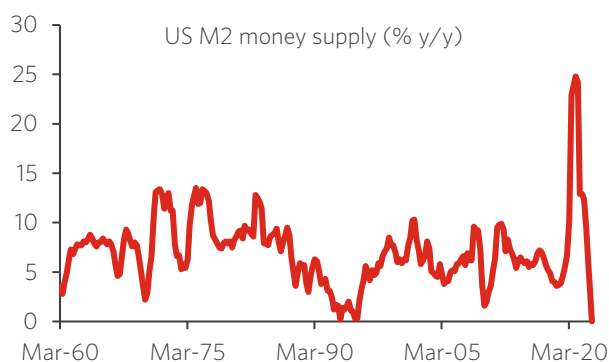
Economic troubles are, nevertheless, bubbling in Europe, leaving growth prospects for this year weaker than in the US. The rise in cost of living due to energy last year (as a share of average household consumption) went as high as 12% for Italy and 10% for the UK. As such, we expect tighter financial conditions and a high cost of living to leave growth at negative 0.6% for the Eurozone and negative 1% for the UK this year.

While inflation dominated news headlines last year, convincing signs of supply-side inflation receding could result in disinflation driving the narrative this year. The New York Fed President John Williams remarked that the outer layer of the inflation onion has shown signs of relief. Supply-chain bottlenecks have been easing consistently. Supplier delivery times have shortened drastically, while the New York Fed Global Supply Chain Pressure Index has tumbled.

While Williams notes that core goods inflation, which makes up the middle layer of the onion, remains high, there are signs of this reversing. Moreover, continued dollar strength has reined in inflation on imported goods.

Williams warns that the innermost layer of the onion, underlying inflation, is where the most attention needs to be paid. Stickiness in inflation in this area of the consumer basket can result in a slower pull back to the Fed's inflation target of 2%.

**Chart 14: Collapse in growth of M2 money supply**



Source: Bloomberg, Momentum Investments  
Data up to November 2022

That said, forward-looking signs are painting an encouraging picture. Growth in M2 money supply has

dropped from over 25% 18 months ago to 0% (see chart 14). Given its typical 18-month lag with inflation, price pressures should ease significantly in the coming quarters. Indicators such as the Zillow Observed Rent Index point to a softening in rental inflation, while fewer small businesses are planning to raise selling prices. Overstocked retailers in the US will also find it difficult to pass on higher costs in an environment of slowing excess demand.

While the Bloomberg consensus suggests that we have passed the peak in inflation, globally, inflation is likely to remain above target this year. The median consensus shifted its expectation for headline inflation in DMs for this year from 2.1% at the end of 2021 to 5.4% at the end of 2022. Similarly, the market's projection for headline inflation in EMs rose from 3.6% to 5.8% in the same period.

Geopolitical conflict, which has sucker-punched the global economy, has driven investors into safe-haven investments, including the US dollar. This exacerbated inflationary pressures for many economies. Research by the European Central Bank further attributes a firmer US dollar to better relative macroeconomic outcomes in the US and a higher interest rate differential with the Eurozone. While these factors can continue to drive dollar strength in the interim, we expect narrower interest rate differentials from the second half of this year to drive dollar weakness. As interest rates decline in the US economy, investors are likely to transfer money out of the US and into other countries that offer a higher interest rate. These capital flow adjustments are likely to lead to a weakening in the US dollar against the currencies of higher-yielding countries.

Market-implied policy rates expect the US Fed to wrap up its interest rate hiking cycle in the first half of this year, peaking at 5%. The first cut has been pencilled in before the end of this year, following a pause after the last hike.

The dollar is expected to follow a depreciating path over the medium to longer term, but the rate of depreciation is likely to slow beyond this year. US government budget and current account deficit projections look unfavourable relative to the Eurozone in the medium to longer term, while a rich valuation on a purchasing

power parity calculation further suggests some retracement in the dollar.

Central banks' focus up until now has been to tame inflation even as recession risks loom. While reaching a peak in global inflation is a necessary condition and may be enough for central banks to reach a peak in hawkishness, it is not seen as sufficient for an actual pivot towards an easing in monetary policy. In particular, we believe that central banks need to see a clear deceleration in underlying inflation or a reversal in tight labour markets.

Fixed income markets in the United Kingdom punished the former administration, led by Liz Truss, at the end of the third quarter of 2022, when she delivered budget proposals that markets expected would only spur inflation and necessitate even more tightening in monetary policy.

Fiscal policy must work in concert with monetary policy, otherwise, the IMF warns, the fight to douse inflation will only be prolonged. The World Bank points out that the fraction of countries tightening fiscal policies this year is expected to reach its highest level since the early 1990s. As such, this could amplify the negative effects of tighter monetary policy on growth.

While previously, DM governments could enact fiscal stimulus without worrying too much about higher inflation, we have now shifted to an era with more explicit policy trade-offs. Nonetheless, we believe that in a slower growth environment, with higher levels of social unrest, governments around the world will be tempted to lean on fiscal policies to alleviate growth troubles. Moreover, electoral cycles are expected to increasingly influence fiscal decisions in a more politically polarised world.

In the US, analysts warn that reaching the debt ceiling could land up being used as a political tool as it was in 2011, resulting in a sovereign downgrade by Standard and Poor Global Ratings. Vox warns that the outcome of the likely standoff could potentially end in a further weakening in parts of government that have already been underfunded for a decade, including education, transport and water resources and international affairs.

EMs have experienced the fastest rise in debt in the past decade than they have in the past 50 years. Moreover, higher global borrowing costs have intensified financial stress for vulnerable countries with a large share of foreign-denominated debt.

A backdrop of weaker global growth is likely to increase EM vulnerability. A sharp slowdown in the US or Eurozone or softer-than-expected growth in China could trigger acute financial stress in emerging and developing countries. While we believe that larger middle-income countries are economically and fiscally fit to weather this storm, poorer and more-economically exposed nations will likely find it difficult to avoid fiscal and debt distress. As such, more dominoes could fall in this narrower composite.

Within the EM composite, prospects are brightening for China. A gradual loosening of zero-COVID policies, an investment in climate transition and a frontloading of infrastructure projects are likely to fuel a recovery in China this year. While we acknowledge that property market woes may spill negatively into economic growth, leaving the expected growth figure for this year short of Beijing's 5.5% target, a faster and smoother relaxation in stringent lockdown regulations in China could result in a rebound in downtrodden consumer confidence. As such, a revival in household spending and tourism could deliver an upside risk to the outlook for the global economy this year.

Another area which may surprise positively is Europe. Analysts suggest that Russia picked the worst year for gas blackmail. Not only has Europe experienced a record-warm season so far, but the region has had unprecedented late gas injections. Moreover, liquified natural gas supplies hit a record high and disappointing demand in China has lowered global demand for energy. With Europe's gas storage level reaching the highest level in over a decade, supplies may just be sufficient to meet demand, lowering the need for caps on energy demand and leading to a potentially better outcome on European growth.

The US economy could likewise deliver a positive growth surprise this year. If real disposable incomes recover more strongly than anticipated, owing to higher

nominal wages, lower inflation and strong jobs growth, a more buoyant US growth wave could lift all economic ships next year.

Nonetheless, one can also easily think of ways in which the global economic situation could get worse. A higher magnitude and longer duration in interest rate tightening could push the US economy into a more painful slump, dragging growth in all economies lower.

In addition, a colder-than-expected winter in Europe could raise the urgency of Europe's energy crisis, enforcing caps on usage and lowering demand.

Moreover, a bumpier transition to lower COVID-19 restrictions in China could set a gloomier scene for

growth and consequently commodity prices, worsening the outlook for EMs that are highly reliant on trade.

China also faces the risk of rising geoeconomic fragmentation. The US' latest across-the-board sanctions on Chinese companies in the semiconductor industry represent the country's latest efforts to contain Beijing's technology and military advances and indicate a further decoupling between the world's largest countries. This is likely to accelerate the decline in globalisation already underway, brought on by onshoring and nearshoring to reduce reliance on global supply chains.

## Global slowdown and local economic and political challenges darken SA's outlook

Against this backdrop of dimmer global growth, a slow grind lower in elevated inflation and geopolitically, a more fragmented world, growth in SA is set to moderate from an expected 2.5% in 2022 to 1.1% this year. Recent negative political developments raising uncertainty over the leadership of the country pose significant downside risks to this view.

Lower growth in some of SA's main trading partners will reduce demand for our exports, leaving private demand and investment as the main contributors to growth. Structural challenges and mounting headwinds will continue to dampen local demand, nonetheless. The pace of increase in nominal wages and social grants has failed to keep up with the latest surge in inflation, while employment prospects are weakening given continued downgrades to this year's expected growth outcome. Meanwhile, businesses remain constrained by softer expected demand, a staggered pace of economic reforms and policy uncertainty.

Uncertainty over President Cyril Ramaphosa's continued leadership in SA, following his alleged failure to properly report a robbery at his game farm, has raised the risk of a slower pace of reforms and lowers government's ability to provide more predictable and stable policy outcomes. In a more negative scenario, in which a successor within the ruling party does not

continue to champion the reforms Ramaphosa has already set in motion, we could see an unwinding of progress in key areas, such as the fight against corruption and the reinstatement of SA's institutional credibility.

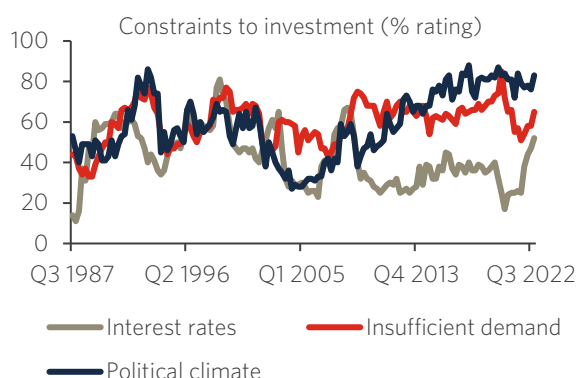
In our view, output remains further at risk from persistent disruptions at malfunctioning state-owned enterprises. Electricity outages have ramped up in intensity, with a third of offline generating capacity arising from unplanned outages. Crippling strikes, theft and vandalism have, in addition, undermined Transnet's contribution to economic growth given the entity's importance in transporting freight to local markets and ports. *BusinessTech* reports that, in 2021, SA's rail network carried the lowest volume in a decade. Not only does this cause further damage to SA's road infrastructure, but it also pushes up operational costs for businesses.

Although embedded generation projects are gaining traction and should underpin growth this year, the recovery in fixed investment is unlikely to be broad-based due to ongoing challenges suppressing business sentiment. According to the Bureau for Economic Research (BER), 83% of manufacturers still cite the general political climate as an obstacle to investment in SA. This is expected to climb further on the back of



recent unfavourable local political developments. Around 65% rate insufficient demand as a constraint and a rising share (from 17% in the third quarter of 2020 to 52% in the fourth quarter of 2022) agree that short-term interest rates are hindering investment prospects (see chart 15).

**Chart 15: Constraints to investment in SA**



Source: BER, Momentum Investments  
Data up to Q4 2022

Relative to many of SA's peers, the overshoot in the inflation target has been relatively modest. The high base effect created in food and fuel inflation should deliver a welcome reprieve this year. At an underlying level, wage inflation shows little signs of developing into a wage-price spiral. The rise in services inflation has also been tame, partly owing to above-average vacancies in the rental market, which has resulted in downward pressure on rental escalations.

Although inflation in rand-sensitive core goods has surprised to the upside, the rand could strengthen by the end of this year on an improved global risk backdrop and a more conducive environment for capital flows into EMs. Inflation pressures, at a headline level, are expected to unwind from an expected 6.9% in 2022 to 5.8% this year. Though underlying measures of local inflation are likely to react with a lag, given a delay in pass-through effects, we anticipate core inflation to remain well within target in the medium term.

Conforming with warnings heralded by the IMF and World Bank, the SARB cautioned against the risk of under-tightening and clarified that policy rates may

expand beyond the neutral level if upside risks to the inflation trajectory are viewed as material.

We anticipate a further 50 basis points in the current series of interest rate hikes, leaving the repo at 7.50%. But we acknowledge the risk of additional tightening should inflation prove stickier than projected. If persistent local political uncertainty bids the rand weaker on a more sustainable basis, the outlook for inflation expectations could come under threat, leading to a tighter stance on monetary policy.

While decisive intervention by Treasury lowers the probability of a greylisting event, shortcomings in the hollowed out criminal justice system keep the probability as more likely than not. While investors are well versed on the structural challenges the country faces, limiting the impact of a greylisting event on SA asset classes, perceived inaction by SA to address the FATF's concerns or a reversal in anti-corruption reform efforts to date would result in a larger negative effect on economic and capital markets.

If SA displays a concerted effort to address the FATF's recommendations within an 18- to 24-month period, as was the case with Mauritius and Botswana, it could convince the country's counterparts to maintain relationships in the interim. Intellidex notes under this scenario, GDP losses would be less than 1% and any associated capital outflows would be small in magnitude and relatively short-lived. Intellidex paints a more bearish risk scenario, in which SA remains on the greylist for as long as five years. Without any convincing action by SA's policymakers, regulators and law enforcement agencies to address the FATF's concerns, SA could lose up to 3% of GDP in this worst-case scenario.

Although the rating agencies left SA's sovereign rating unchanged at the latest review, in line with expectations, we maintain our concerns over downward pressure on ratings in the medium to longer term on weak growth potential, an uncertain political outlook, rising socio-economic risks and increasing social demands on the budget.

The IMF has warned that fiscal policy should remain aligned with monetary policy in the next while to ensure that authorities can quell inflationary pressures. While fiscal authorities, locally, have promised to rebuild fiscal buffers and maintain a prudent approach to expenditure, the near-term improvement in SA's fiscal position has largely been thanks to a commodity price boon. In our view, this fiscal bonanza has merely masked underlying fiscal imbalances that the country has failed to resolve for over a decade, due to bad governance and anaemic growth. Real economic stagnation forecasted in the medium term is suggestive of continued fiscal weakness ahead.

Despite some buffer built into the unallocated and contingency reserves, the fiscal consolidation path that Treasury has proposed, to stabilise debt in the near term, remains questionable given the exclusion of major risks in the baseline and an implausible spending trajectory. In our view, debt levels are already high, resulting in a large interest bill, crowding out more useful forms of government expenditure. Rising social demands and support for parastatals and financially bankrupt municipalities will only add to the challenge of stabilising debt at the proposed 71.4% of GDP in SA.

The prospect of SA's sovereign rating returning to investment grade remains some way off in our view. This will rely on implementing growth-enhancing

reforms to activate economic opportunities for poor households. In addition, deregulating the economy is viewed as a prerequisite for local businesses to grow, absorb labour and support sustainable revenue streams.

Moreover, curtailing growth in the wage bill and finding a long-term financial solution for state-owned enterprises, which creates economic value, can stabilise government finances in the long run. Conviction in government's willingness and ability to implement unambiguous policies quickly and efficiently can further jumpstart the economy and raise market confidence.

In this light, the outcome of the leadership of SA and the appetite to further the country's structural reform agenda remain critical to growth, investment and socio-economic outcomes.

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