



Market and economic outlook: October 2023

Highlights

Markets

- Near-term recession fears have faded in the United States (US) in response to recent stronger-than-anticipated economic activity data. However, some indicators still point to a reasonable likelihood of a US recession in the medium term.
- As has been the case for US bonds for over a year now, good economic growth news recently also became bad news for US equities due to worries that a good growth outcome implies policy rates will remain higher for longer. The narrow-based nature of this year's US equity market advance also brings the sustainability of ongoing market upside into question.
- US bonds now trade at a discount to US equities, a rarity this century, making them historically cheap alternatives to equities.
- Our preference to take a more defensive stance in our portfolios, makes us cautious about large exposure to the global property asset class in the interim.
- South African (SA) equities still trade at huge valuation discounts to the rest of the world and its history. Although the SA equity market will likely also suffer during any global equity drawdowns in risk-off periods, it could perform relatively better in subsequent risk-on recoveries due to its positive valuation underpin.
- 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 be 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 recently expected falling inflation and is currently cheap versus history.
- Although SA listed property companies are experiencing improving operational performance (in terms of vacancy rates, as well as net operating income and property values outside the Office subsector), financial metrics have deteriorated (e.g. loan-to value, interest cover and the cost of debt).
- There is always a strategic rationale for gold as a portfolio risk diversifier, because it is expected to hold its value through turbulent times and has limited correlation with other asset classes. Historically, the rand gold price has been a strong relative asset class performer for a SA investor.

Economics

- Global growth is expected to slow as the effect of past interest rate hikes permeates the real economy, gradually eroding aggregate demand.
- Substantial fiscal support has differentiated the impact on growth in this tightening cycle providing a significant fiscal channel of support to the private sector at a time when interest rates were rising.

- Nevertheless, after a robust sprint last year, the US labour market is now experiencing more modest gains as supply aligns with demand and several sectors reach full employment. Additionally, average hourly earnings are falling short of projections, indicating a dip in inflationary pressures and reflecting the impact of previous interest rate hikes.
- With inflation slowing and signs emerging that past monetary policy tightening is having an effect on the economy, it is likely that the end is in sight for global central banks. But even if interest rates have not yet peaked, further hikes should be less consequential for financial markets given the extent of rate tightening so far.
- Interest rate cuts are nonetheless still seen to be some way off. Central banks are likely nervous to prematurely declare a victory on taming inflation and will likely maintain restrictive policy until inflation is sustainably bound closer to the central bank target.
- Although structural bottlenecks are likely to cap SA's growth recovery to 1% next year and 1.7% in the year after, tangible progress on priority reforms which have been identified for their potential impact on economic growth and job creation point to better growth conditions ahead and could provide a healthy platform for a 2% handle on medium-term growth outcomes.
- The combination of a sizeable revenue under-shoot and expenditure overrun is likely to see government's fiscal deficit widen by a further 1% to 1.5% over the medium-term framework relative to Treasury's February estimates. This is expected to prevent any meaningful debt stabilisation in the next while, keeping the interest bill high.
- Even though we expect inflation to resume its glidepath toward the 4.5% midpoint of the target band on a more sustainable basis, SA interest rates are likely to stay on hold until the second quarter of 2024 to counter fiscal dominance risks and continued upside risks to the inflation profile.

Global markets unsettled by restrictive monetary policy and higher oil prices

Reality set in for global equity markets as the robust performance observed in the first half of the year gave way to pressure on risk assets in the third quarter. Fresh concerns over the prospect of a US government shutdown and strong signals from major central banks, indicating that interest rates would remain at their highest levels in decades for some time to keep inflation in check, kept financial markets on the backfoot.

Wall Street's fear gauge (the CBOE Volatility Index or VIX) rose four points during the quarter and ended September at 18.5 points. The *Financial Times* reports that trading in options tied to the VIX is on course to hit a record volume this year, already registering at 40% higher than a year ago. The *Financial Times* attributes this rise to the market's need to hedge their positions amid the current fragile stock market rally year to date. Relative to its long-term average of 19.4 points since 1990, the VIX has trended at a lower average of 17.4 year to date, increasing the chances of a larger payout should the index suddenly shoot higher.

Although the Merrill Lynch Option Volatility Estimate (MOVE) Index, which captures a yield curve-weighted

index of the normalised implied volatility on one-month Treasury options, remains more than 70 points lower than the year-to-date high of 198 points in March 2023, the index reacted more strongly than the VIX during the third quarter and shot up 17 points. The rise in the MOVE Index likely reflected global growth fears following softer growth outcomes in China and a more synchronised narrative across major developed market (DM) central banks that monetary policy will remain restrictive for longer to contain inflationary pressures.

According to *Cbrates*, there have been 143 interest rate hikes so far this year, globally, relative to only 50 cuts. The pace of rate increases across the world has slowed since the second quarter from 47 to 31 in the third quarter, while the number of cuts remained constant at 21. Interest rates have been hiked by a cumulative 525 basis points in the US and 450 basis points in the Eurozone since the start of 2022, while interest rates have surged nearly 525 basis points in the United Kingdom since the start of the interest rate hiking cycle in December 2021.

The Bitcoin price slid 11.5% lower from US\$30 472 at the end of June to US\$26 969 at the end of September 2023 partly on the back of the cryptocurrency sector increasingly becoming a target for hackers. A report by *Immunefi* notes that losses from cyberattacks were up nearly 60% in the third quarter of the year, amounting to US\$685 million. A weaker growth forecast projected for major developing economies next year likely also contributed to the slowdown in the price of Bitcoin.

Despite Chinese growth forecasts being pared back for both this year and next, global commodity prices picked up by 4.7% during the third quarter. The Bloomberg Commodity Price Index (the four largest weights in this index include gold at 15%, WTI Crude oil at 8%, natural gas at 8% and Brent Crude oil at 7%) remained 6.2% weaker on a year-to-date basis.

Price movements across energy-related commodities have been a mixed bag year to date. The international price of Brent Crude oil is nearly 6% higher since the end of 2022, in contrast to natural gas prices which are down between 35% and 50% over the same period. Within metals, iron ore prices were higher year to date and relatively flat for gold while the nickel price dropped the most. Aluminium and copper prices dipped by roughly 3% year to date, while the price of steel plunged 11% over the same period.

The dollar price of gold edged 3.7% lower during the third quarter in line with a pause in interest rates by the US Federal Reserve (Fed) but was broadly unchanged relative to the end of 2022. Meanwhile, the dollar price of platinum and palladium inched higher by 0.2% and 1.4% (respectively) during the third quarter but remained significantly lower year to date at 18.4% and 34% weaker, respectively. Within agricultural commodities, the biggest gainers were cattle, cocoa and sugar in the third quarter, while the biggest price declines were evident for soybean, wheat and corn, driving expectations for a further decline in global headline inflation.

After a firm start to the quarter, global equities retreated as the tech giants went into reverse. The MSCI All Country World Index lost 3.4% in the third quarter but still advanced by 9.9% since the start of the

year. The quarterly underperformance was driven by a poor showing in both the developed and emerging market (EM) composites.

The MSCI DM Index pulled back 3.5% in the third quarter, dragged lower by European equities (down 4.8%). This decline was attributed to a string of downbeat earnings reports, exacerbated by a prevailing 'higher-for-longer' central bank stance, which knocked sentiment harder.

Elsewhere within the DM composite, US equities dipped by 3.3% in the quarter, taking the year-to-date performance down to 13.1%. Energy and communication stocks outperformed in the quarter, while utilities and healthcare lagged. Year to date, communications and technology-related shares led the overall index higher, while utilities and consumer staples were in the red.

Meanwhile, the Japanese Nikkei 225 Index shed 3.3% between the end of June and the end of September 2023, with yen weakness continuing to act as a tailwind. Nonetheless, the year-to-date performance remained impressive at 24.4%.

EM stocks experienced a comparatively milder fall during the quarter relative to their DM counterparts. The MSCI EM Index lost 2.9% in the third quarter as worries over the state of the Chinese property sector resurfaced, despite a number of stimulus measures being announced by Chinese authorities. Food, media and telecommunication stocks were hit the hardest while energy counters outperformed in the quarter.

Equity markets in Latin America suffered a 4.7% setback as investors began to reprice expectations for 'higher-for-longer' rates. The MSCI Asia Index followed with a 2.9% loss, while the decline in equity markets in Europe, the Middle East and Africa (EMEA) was comparatively restrained at 1.8%.

A difficult quarter for equity market investors and a downbeat outlook on China have shifted the market's focus towards the relatively attractive valuations of fixed income asset classes. The narrative of 'higher-for-longer' and a rising term premium have fed into higher

bond yields. The yield on the US 10-year government bond picked up 73 basis points to 4.7% (levels not seen since before the Global Financial Crisis (GFC)) in the third quarter, while the German 10-year government bond yield sold off 45 basis points to end September at 2.8%.

While the Fed's dot plot - a chart that records each Fed official's projection for the central bank's key short-term interest rate - suggests one more interest rate hike in the US, markets were taken aback by the shift in projections for interest rate cuts in 2024 (50 basis points in total relative to 100 basis points at the June 2023 meeting). Across in the Eurozone, markets have priced in the end of the rate hiking cycle but only expect the first cut in the third quarter of next year.

Mimicking the mild uptick in risk aversion in equity markets, the JP Morgan EM Bond Index (EMBI) spread edged up one point and ended the quarter at 364 points. Argentina and China experienced the largest quarterly widening in credit default swap (CDS) spreads of 202 points and 37 points, respectively, in the third quarter of the year, while spreads narrowed the most for Turkey (19 points) as economic policies underwent a significant turnaround, necessitating higher interest rates to control rampant inflation.

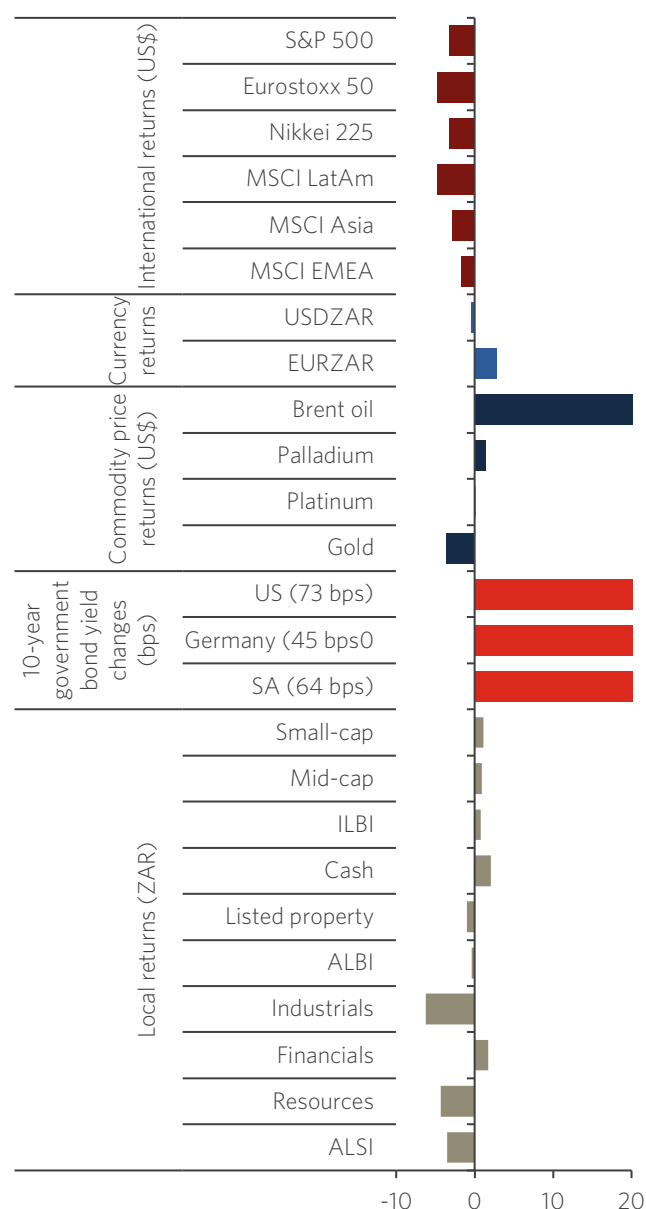
The local equity market mirrored the performance of its global counterparts, experiencing a 3.5% drop in the quarter (see chart 1). This was in response to the 'higher-for-longer' narrative in markets, along with increased levels of planned maintenance leading to more intense loadshedding, especially as maintenance activities intensified with the arrival of warmer weather.

Gains in financial shares (1.7%) in the quarter were wiped out by losses in resource and industrial counters. The FTSE/JSE Resources Index sank 4.3% in the third quarter despite firmer global commodity prices, while the FTSE/JSE Industrials Index was knocked harder, falling by 6.2% in the quarter.

The FTSE/JSE Mid-cap index ended the quarter 0.9% in the black while small-cap equities advanced 1.1%.

In SA's fixed income markets, the 10-year government bond yield sold off 64 basis points in the quarter, after touching an intra-quarter high of 12.2%. The JSE Assa All Bond Index declined 0.4% for the quarter, with the JSE Assa Government ILB Index rising by 0.8% in the corresponding period. The FTSE/JSE SA Listed Property Index eased 1% in the third quarter of the year.

Chart 1: Quarterly asset class returns (%)



Source: Iress, Momentum Investments

Chart truncated for US, German and SA 10-year bond yields

Slower growth in China, continued hawkish central bank rhetoric and prospects for a more stagflationary

outcome in the Eurozone hurt EM currencies during the third quarter. After a stellar second quarter performance, the Argentine peso was the worst-performing currency in the third quarter, from a basket of major EM currencies, weakening by 26.7% against the US dollar. The Chilean peso followed with a 10% depreciation over the same period as falling interest rates undermined the currency's appeal to carry traders. This nevertheless benefited the Colombian peso, which was the best-performing currency in the third quarter as investors piled into the Chilean peso's regional peer.

The rand weakened marginally by 0.4% against the US dollar in the third quarter of the year as the currency reacted to weaker Chinese data and property sector stress which compounded market anxieties. Year to

date, the rand was the fourth weakest performing currency against the US dollar (10%) after the Argentine peso (49.3%), the Turkish lira (31.8%) and Russian rouble (24%).

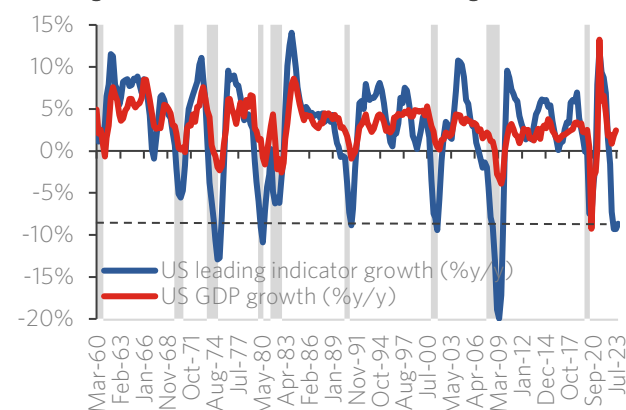
During the third quarter, the rand strengthened 2.8% against the euro, suggesting that dollar strength also affected the rand's marginally poorer performance during the quarter.

In line with local bond yields selling off, SA's ten-year CDS spread widened by 17 points in the quarter to 393, tracking 37 points above levels at the start of the year. This is likely in part due to rising fiscal concerns in the local environment as revenues come under pressure and expenditure overshoots.

US recession fears have faded for now, but have not disappeared completely

US growth expectations have improved rapidly in recent months as activity indicators turned out stronger than previously anticipated. The consensus forecast for 2023 growth was barely above 1% as recently as June of this year. Since then, the forecast has been upped to almost 2% for this year. As a result, near-term recession fears have faded in the US. However, some indicators still point to a reasonable likelihood for US recession in the medium term. The New York Fed's recession probability model currently points to a two-thirds likelihood for a US recession in the next year – worryingly, it has never given a false signal at this level in history. Similarly, the US leading economic indicator (LEI) also points to a decent chance for possible US recession. Momentum in this composite indicator, which includes 10 variables across the US manufacturing sector, labour market, housing sector, the equity, credit and rate markets, as well as consumer sentiment, remains significantly negative (see chart 2). Never before across 60 years of history has the LEI momentum been this negative without a recession following. Furthermore, the ongoing tightening of lending standards by US banks should be reflected over time in slowing economic and profit momentum.

Chart 2: Never before has US LEI momentum been this negative without recession following

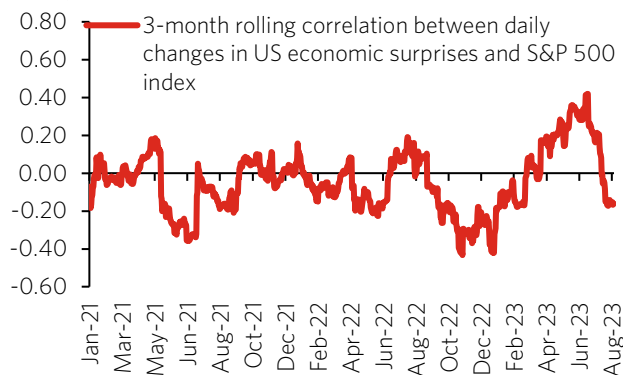


Source: Iress, Momentum Investments
Shaded areas depict official US recessions

Whereas good US growth news has been consistently negative for US bonds for well over a year now (with positive growth surprises reflected in higher bond yields), chart 3 shows that good economic growth news has also more recently become bad news for US equities (with positive growth surprises associated with a lower equity market). This can most likely be attributed to worries that a good growth outcome will have less favourable implications for the US interest rate cycle, with policy rates remaining higher for longer.

Economic surprises thus now seem to be a stronger driver for policy rate expectations than profit views.

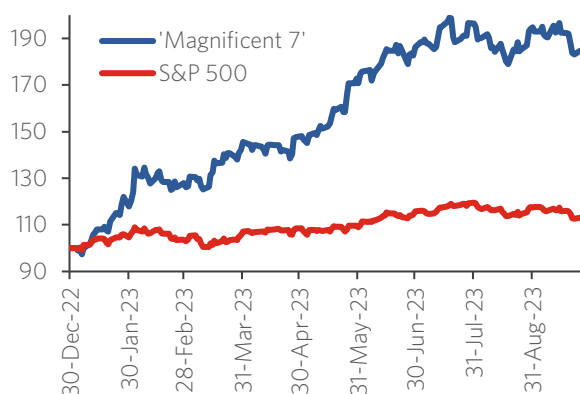
Chart 3: Good growth news now equals bad news for US equities



Source: Bloomberg, Momentum Investments

Although the aggregate 2023 performance of the US equity market at face value may seem solid, closer inspection reveals that this can be attributed solely to a handful of large shares that shot the lights out. The share prices of the so-called 'Magnificent 7' grouping of Amazon, Apple, Alphabet (Google), Meta (Facebook), Microsoft, Nvidia and Tesla were predominantly catapulted higher by Artificial Intelligence (AI) hype this year. While this basket of seven shares was up by around 85% year-to-date at the time of writing, the other 493 shares in the S&P 500 were down a combined 10% in the year, leaving the overall index around 13% higher in 2023 (see chart 4). Such a narrow-based market advance brings the sustainability of ongoing market upside into question.

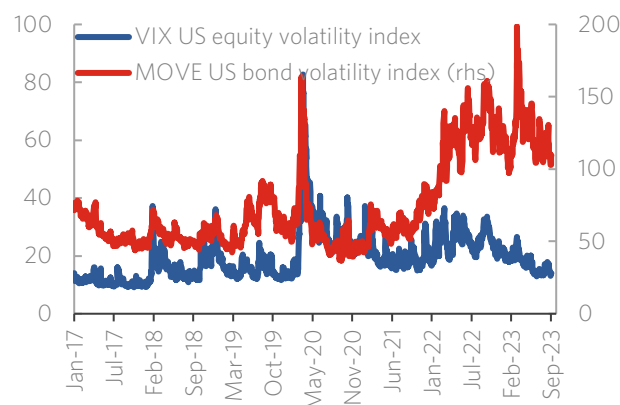
Chart 4: US equity market breadth has been weak this year



Source: Bloomberg, Momentum Investments

There has been a big divergence between the implied volatilities of the US equity (VIX) and bond (MOVE) markets in the last 18 months (see chart 5). Despite ongoing uncertainties about geopolitics, US growth, inflation and policy rates, this is not reflected in the lowest equity volatility since pre-COVID (Feb-20). Contrast this with bond volatility which is significantly above pre-COVID levels. It thus seems that the US equity market is much more complacent than the bond market about the economic outlook. Research by Credit Suisse concludes that when lots of good news and little bad news have been discounted historically by the US equity market at similarly low VIX levels than is currently prevalent, forward US equity returns have been constrained.

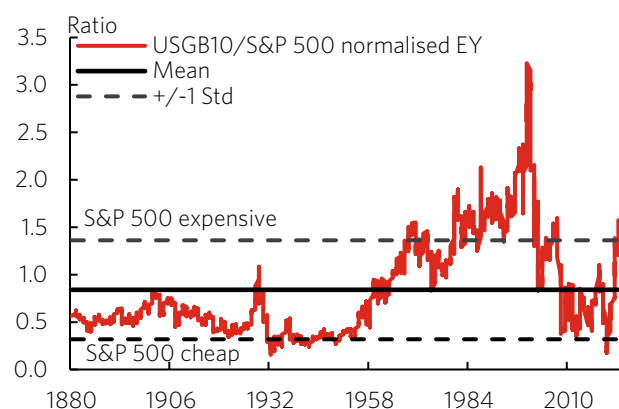
Chart 5: US equity market seems complacent about risks



Source: Bloomberg, Momentum Investments

Although US bond yields have continued to rise in 2023 on the back of a resilient US economy, fiscal concerns and remaining inflation risks, equity valuations have not adjusted downwards. As a result, US bonds now trade at a discount to US equities, a rarity this century. Comparing the current US bond yield to the through-the-cycle equity earnings yield, equities are now more than one standard deviation expensive relative to bonds against history (see chart 6). This was not the case for a long time since the GFC, when equities were consistently cheap versus bonds.

Chart 6: US bonds increasingly cheap versus equities



Source: Iress, Momentum Investments

US real estate investment trust (REIT) occupancy rates remain high outside the Office sector and US balance sheets have strengthened since the GFC with lower leverage and a longer maturity profile. However, elevated Office sector leverage could exacerbate near-term operating challenges and lead to dividend cuts and asset sales.

Although REIT sensitivity to interest rates has declined since the GFC with more fixed-rate debt at lower interest rates and there has been no material deterioration in debt affordability yet, there is a risk for

more distressed sales due to higher debt levels associated with the rapid rise in interest rates and banks tightening lending standards.

Global property currently looks expensive versus fixed income asset classes like nominal and real US Treasuries and global investment grade bonds, but cheap against equities.

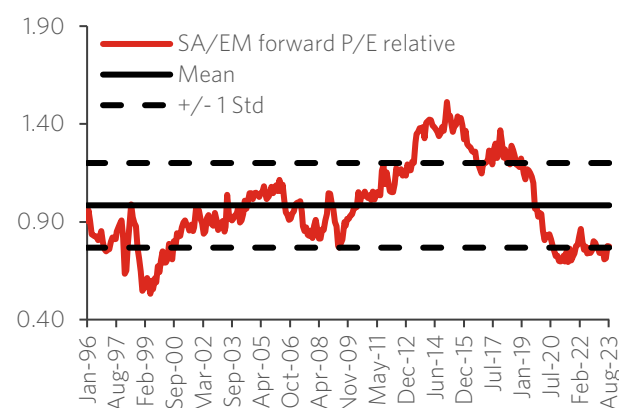
In aggregate, our preference to take a more defensive stance in our portfolios against the backdrop of lingering US recession risks and uncertainties about the path for global inflation and policy rates, makes us cautious about exposure to the global property asset class in the interim.

For SA investors, we prefer SA asset classes over global assets in the next year. Firstly, our expectation for some rand appreciation as global risk appetite improves into 2024 in anticipation of future DM policy rate declines, would erode the local currency returns from global assets. Furthermore, SA assets are supported by more attractive valuations than global assets and discount significant amounts of bad news.

Valuation underpin remains for SA equity market

SA equities continue to be attractively valued relative to global equities, as well as against its history. This should provide some support in case of potential global equity drawdowns, but more so during subsequent risk-on recoveries when global risk appetite increases. SA equity valuations remain cheap against EM (and even more so against DM), with SA a superior dividend payer within EM, cheap versus history on a Price/Book basis and at a large forward P/E discount to EM (see chart 7). Only in the period between the 1998 EM crisis and the 2000 dot-com collapse did SA equities trade at a larger forward P/E discount versus EM than the current one standard deviation discount.

Chart 7: SA forward P/E relative to EM

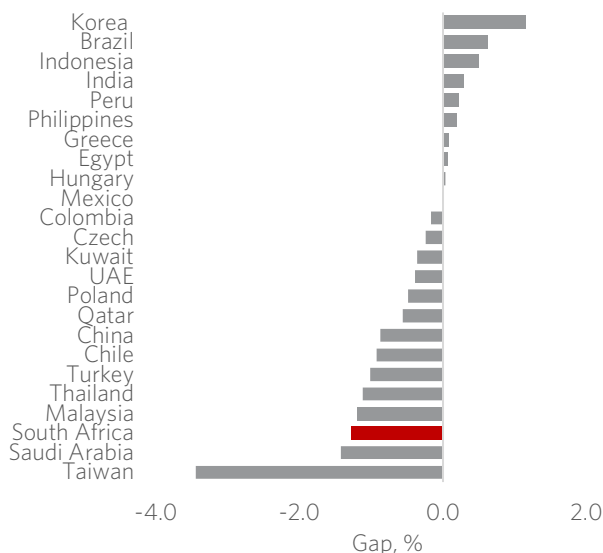


Source: SBG Securities

Furthermore, SA is the third most underowned market within global EM (GEM) equity funds (see chart 8) and as such should have meaningful rerating potential from current cheap valuations when global risk appetite

improves and global capital hunts for more exotic destinations.

Chart 8: GEM funds' % allocations to EM countries versus benchmark

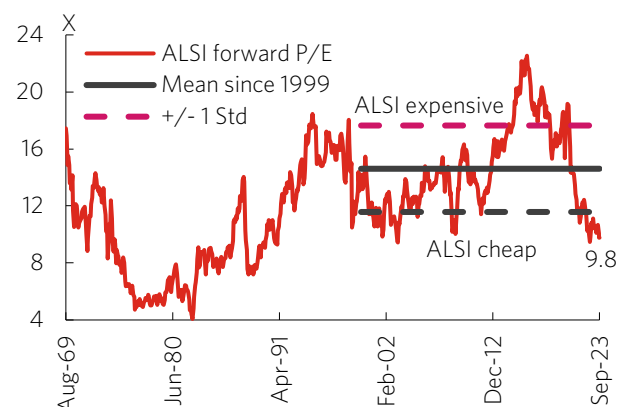


Source: SBG Securities

Even assuming a conservative 8% earnings growth in the next year, the SA equity market is now one and a half standard deviations cheap on a forward P/E basis against the average since 1999 (see chart 9). In our view, a lot of bad news is currently priced into SA equities, enhancing the future return potential from

current levels. The SA economy will likely remain trapped in a low-growth quagmire until the country's electricity and logistical deficiencies are rectified and structural policy reforms are successfully implemented to drive the country's growth potential to a higher plain. However, the fortunate reality for investors in the SA equity market is that the local economy is only a secondary driver for the overall local stock market. We have relayed before that analysis done by RMB Morgan Stanley shows that only around 30% of the aggregated operating performance of the companies in the JSE Top 40 index currently originates from SA.

Chart 9: ALSI forward P/E

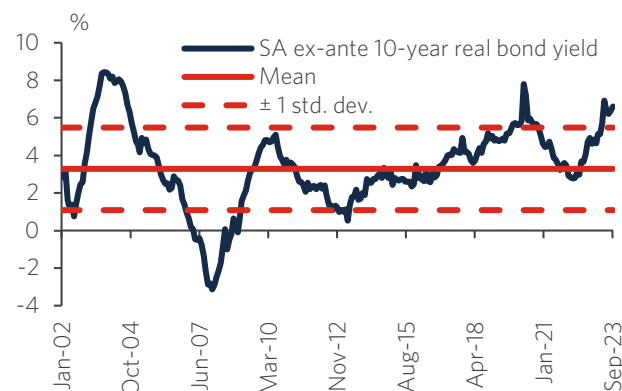


Source: Iress, Momentum Investments

SA bonds incorporate high fiscal and country risk premia

Although DM government bond yields have risen meaningfully and inflation rates have come down from peak levels, only US real bond yields within DM have moved into positive territory. Although there are rampant inflation outliers like Türkiye 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 strongly positive in most EM countries, with SA's real yields among the highest.

Chart 10: SA prospective real bond yields are well above historical averages

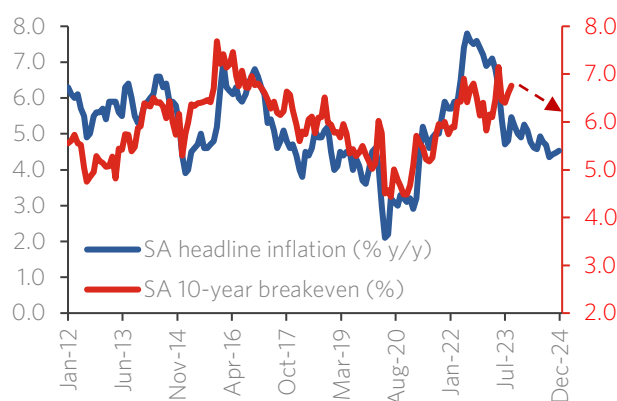


Source: IRESS, Momentum Investments

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 around one and a half standard deviations higher than its historical average (see chart 10). In our view, SA's high real bond yields already discount high fiscal and country risk premiums.

In the ILB space, lower-than-average monthly inflation accruals are expected until early 2024. Together with expected break-even tightening as inflation falls in the coming year (see chart 11), this should provide less fundamental support for ILBs going forward.

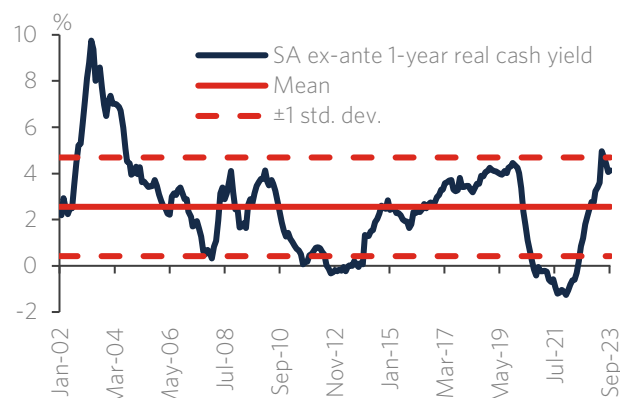
Chart 11: Breakeven tightening expected in line with falling inflation in the coming year



Source: IRESS, Momentum Investments

The prospective SA real cash yield has been rising from a low level in line with policy rate increases and recently expected falling inflation and is currently just less than one standard deviation above its historical average (see chart 12).

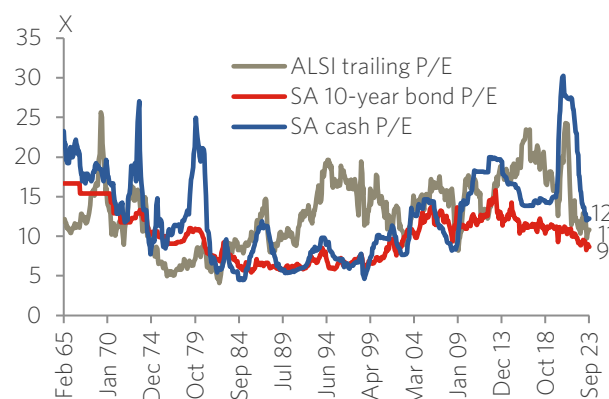
Chart 12: Prospective SA real cash yield



Source: Iress, Momentum Investments

Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013 (see chart 13). Aggressive COVID-related SA Reserve Bank (SARB) interest rate cuts have made cash the most expensive asset class since 2020, but cash is now close to equity valuations after recent sharp rate rises.

Chart 13: SA asset class valuations



Source: Iress, Momentum Investments

Improving operational performance but deteriorating financial metrics for SA property companies

Although SA listed property companies are experiencing improving operational performance (in terms of vacancy rates, as well as net operating income and property values outside the Office subsector), financial metrics have deteriorated somewhat (e.g. loan-to value, interest cover and the cost of debt and hedging). Fortunately, although interest cover ratios have trended lower, they remain above covenants.

In the Retail subsector, vacancy rates have been improving with every reporting cycle post the pandemic. Better trading conditions are supporting a turnaround in negative reversions for some counters. Improved demand for offices is driven by return-to-office corporate policies and loadshedding, but fundamentals remain weak. Although vacancy rates are rolling over, rents remain under pressure and negative

reversions remain the norm. The Industrial sector is achieving growth in income and valuations, with modern logistics benefiting from long lease expiry profiles.

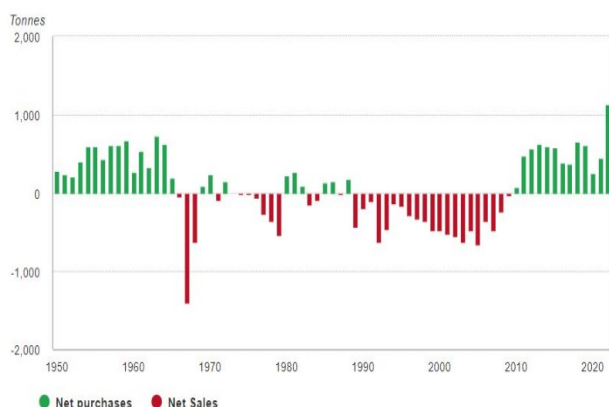
SA listed property nominal and real dividend yields are among the highest in the world. However, from a

portfolio construction perspective, the potential for meaningful listed property return upside from attractive valuation levels must be weighed against the remaining negative fundamental factors.

Strategic rationale for gold as a portfolio diversifier and perceived safe-haven asset

US real rates have been the dominant driver for the US dollar gold price for a couple of decades, as the fundamental driver for gold is the opportunity cost of holding a non-interest-bearing asset. However, this relationship has broken down since the Russia/Ukraine war – we estimate that non-TIPS factors are adding more than \$1,200/oz to the current gold price.

Chart 14: Central bank gold buying highest ever in 2022



Source: Refinitiv, World Gold Council

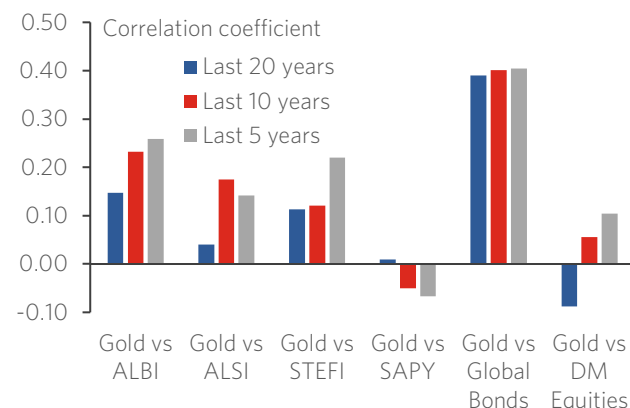
This is likely due to the highest-ever gold buying from global central banks in 2022 (see chart 14), probably for geopolitical and diversification reasons. Central banks have an affinity for gold reserves as it is deemed a safe haven in risk-off periods and does not rely on any issuer or government, unlike currencies and bonds. Gold also enables central banks to diversify their reserves away from assets like US Treasuries and the dollar, particularly for countries wary of future confiscation of their international US dollar reserves should the US decide to impose Russia-like sanctions on them. Banks including those of Türkiye, China, Egypt and Qatar said they bought gold last year. But around two-thirds of the

gold bought by central banks last year was not reported publicly, according to the World Gold Council (WGC).

The strong central bank buying trend has continued this year, with central bank buying in the first half of 2023 the highest on record (dominated by China, Singapore and Poland), despite the substantial 130 tonnes of gold sales by Türkiye in the second quarter of this year.

With geopolitical strife likely to remain high in coming years as deglobalisation continues and a multipolar world order establishes itself (between the West and China), gold is likely to maintain its strategic attractiveness in investment portfolios as a hedge against political volatility and uncertainty. This is already borne out by results from a recent WGC survey where 71% of 57 global central banks indicated that their gold reserves will likely increase in the next 12 months.

Chart 15: Gold has limited correlation with other asset classes



Source: Iress, Bloomberg, Momentum Investments

This will likely maintain the strategic rationale for gold as a portfolio risk diversifier, because it is expected to

hold its value through turbulent times and has limited correlation with other asset classes (see chart 15). For a SA investor, the rand gold price has been a strong relative asset class performer historically, as perennial

rand weakness has provided huge support over many years.

Resilient recovery but rockier road ahead

At the start of the year, the International Monetary Fund (IMF) suggested that 70% of the global growth recovery in 2023 would come from Asia, with China playing a significant role in supporting growth outcomes. Nevertheless, since the beginning of the year, the Bloomberg median consensus estimate on Chinese growth for 2023 has been scaled back from a peak of 5.7% at the start of the year to 5% (in line with forecasts from a year earlier when markets believed a full reopening of the economy would take longer). Additional downgrades are likely to follow suit given tightened restrictions against China, sluggish demand in Europe, persistent weaknesses in the property sector and subdued consumer confidence due to a lacklustre performance in the equity market and high youth unemployment.

While the Chinese government reverted to familiar top-down stimulus measures, a more cautious approach was taken due to concerns that the conventional levels of economic stimulus could exacerbate inefficiencies and disrupt the orderly deflation of debt bubbles in specific sectors. Despite policymakers' steadfast commitment to boost domestic sources of sustainable growth and reduce reliance on external demand, there has been a lag in policy implementation.

Weak price pressure added to concerns over China's economic outlook in the past months. Consumer prices dipped into deflation in July triggering fears of a Japan-style deflationary descent. Nevertheless, factory gate prices which trended in deflationary territory in the first half of this year, recovered into mildly positive territory in July and August. Moreover, core or underlying and services inflation has continued to trend comfortably in positive territory.

In our view, there are further reasons preventing China from plunging into in Japanese debt-deflation setting. Unlike Japan in the 1990s, which was heavily reliant on

the real estate industry, China has broadened its economic focus to new energy markets and the digital economy. Partly due to an appreciation in the yen, Japan's share of global exports plummeted from 8.5% in 1990 to 3.5% in 2020. China, meanwhile, still holds an impressive share of 13% of the global export market. Moreover, China's economy is supported by a huge domestic market.

In the 1990s, equity and property prices ramped up significantly in Japan (and similarly in the US in 2007) within a short space of time. When confidence washed out, these prices crashed. In China, the ascent in prices in the equity and property markets has not been as steep, suggesting that authorities still have an opportunity to deflate rather than pop the bubble.

While Japan's government struggled to spur private sector lending in the economy in the 1990s, China has a state-owned financial system which guarantees lending into the economy, ultimately preventing systemic crises. The change in total borrowing as a share of gross domestic product remains reasonably high in China, supported by corporate and household loans, while the only contraction in credit is evident in corporate shadow credit.

Deflation persisted in Japan, where corporates guided workers' wages lower as firms tried to pay down debt. To date, wage growth in China has been firm, decelerating recently but remaining well in positive territory, even after adjusting for inflation.

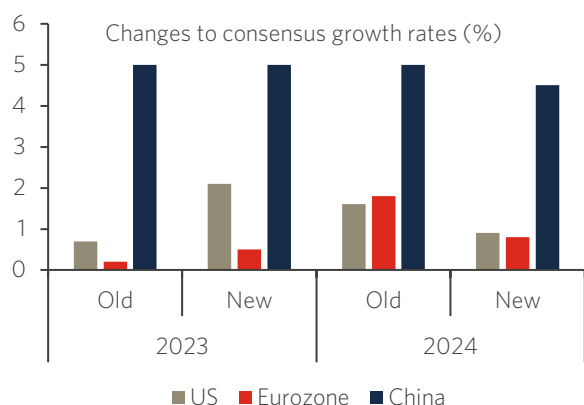
China's ageing population further concerns markets. In 2021, 15% of China's population was aged 65 years and older. This was even higher than Japan's 13% in 1991. Nevertheless, with an unemployment rate of 22% recorded for youth between the ages of 16 and 24 years, surplus labour is likely still available in the

Chinese economy, pushing the problem of an ageing population on the labour market into the future.

With credit becoming a less effective channel to support growth than in the past (a lower Chinese growth multiplier on bank loans) and with the fiscal and credit impulses (the second-order derivative in fiscal spending and lending) turning negative, growth is expected to slow to just below 5% this year, in our view.

Growth is expected to slow elsewhere in the globe as the effect of past interest rate hikes permeates the real economy, gradually eroding aggregate demand. The Bloomberg median consensus expectation for growth in the US for next year slipped from 1.6% a year ago to a trough of 0.6% in July but has since recovered to 0.9%.

Chart 16: Growth downwardly revised for 2024



Source: Bloomberg, Momentum Investments

After a robust sprint last year, the US labour market is now experiencing more modest gains as supply aligns with demand and several sectors reach full employment. The unemployment rate, factoring in discouraged workers and those in part-time roles due to economic reasons, climbed to 7.1% in August - the highest since May 2022. Additionally, average hourly earnings fell short of projections, indicating a dip in inflationary pressures and reflecting the impact of previous rate hikes.

According to a recent *Bloomberg* report, merely 20% of the wealthiest Americans retain their pandemic savings. This is reflected in the notable surge of credit card debt among US households, struggling to meet their cost-of-

living expenses—unfortunately, during a period of substantial increase in credit card interest rates. A net 60% of consumers surveyed quarterly by the University of Michigan have expressed that high interest rates have become a more significant barrier to buying homes, this compares to a peak of 80% in the early 1980s. Similarly, high interest rates are seen as a barrier for a net 10% of consumers considering purchasing a vehicle and a net 20% of consumers wanting to buy large household durables. Moreover, a net 20% of banks are reporting an unwillingness to lend to consumers. This ratio has surpassed the level experienced during the late 1980s recession and is approaching levels experienced during the GFC and the COVID-19 pandemic.

Markets anticipate that growth should remain weak in Europe as past inflation and interest rates bite further into economic activity. The Bloomberg median consensus projects that growth in the Eurozone will improve marginally from an expected 0.5% this year to 0.8% next year, the latter which has been revised lower from a projection of 1.8% a year ago.

Markets have questioned the surprising resilience of the economy and labour market given the sharpest pace of interest rate tightening we have seen in more than forty years. American economist and statistician Milton Friedman's long and variable lags theory partly explains why we have yet to see the full economic impact of prior interest rate hikes given the traditional 12 to 18-month delay in the time it takes changes in monetary policy to affect aggregate demand. Although markets initially assumed the conventional lag would have shortened given the contraction in central bank balance sheets, this has not been the case.

Secondly, pandemic savings pots have kept the economy afloat in spite of tighter policy. Outside of the US, surplus household savings remain healthy and continue to provide support to ongoing economic recoveries.

Finally, substantial fiscal support has differentiated the impact on growth in this tightening cycle. *Project Syndicate* calculates that close to US\$3 trillion in interest was paid on bank reserves since 2008, providing a

significant fiscal channel of support to the private sector at a time when interest rates were rising.

While the integrity of systemically-important bank balance sheets and wholesale funding markets are healthier, historic precedent shows us that there is a delay in the reaction function of risky asset markets. As such, there is a non-negligible chance that the complacency pencilled into global equity markets may be challenged.

With inflation slowing and signs emerging that past monetary policy tightening is having an effect on the economy, the end is likely in sight for global central banks. And even if interest rates have not yet peaked, further hikes should be less consequential for financial markets given the extent of rate tightening so far.

That said, interest rate cuts are still seen to be some way off. Central banks are likely nervous to prematurely declare a victory on taming inflation and will likely maintain restrictive policy until inflation is sustainably bound closer to the central bank target.

The Bank for International Settlements (BIS) discusses the challenges faced by central banks in achieving the so-called 'last mile of disinflation'. The BIS notes that often the final throes of disinflation, which refers to positive but slowing inflation, is challenged by fading base effects. Moreover, there could be a late-cycle catch-up in demand as real purchasing power improves on the back of slowing inflation and a recovery in nominal wages. Lastly, political pressure starts to build on central banks to ease off interest rates as financial stresses mount with a lag. The BIS warns that the retreat in inflation may be slower this time around, given that a higher peak was observed in services inflation during the current episode related to post-pandemic re-openings.

While the initial surge in inflation was prompted by supply chain shortages, which now seem to have eased, supply chains have evolved into a tool for non-military leverage during political negotiations. Political trends and ideological differences are increasingly impacting global supply chains. Looking at the globe's two largest economies, the 'America first' agenda under former President Donald Trump expedited the shift in the US's reliance on manufactured goods imports away from China. Consequently, geopolitical relationships are now playing a significant role as countries strategically establish and diversify their supply chains.

The invasion of Ukraine by Russia has exacerbated the disparities among nations that have experienced unequal benefits from globalisation. This is further expected to shape forthcoming trade and investment strategies, globally.

The expansion of the BRICS grouping, the inclusion of the African Union into the G20 and an increased emphasis on the Global South demonstrates the determination of less developed and emerging nations to break free from Western influence and the dollar's dominance. Nonetheless, Western powers are anything but obsolete, suggesting that nations need to adopt a far nimbler approach to foreign affairs going forward.

Under this new global order, a hardening in geopolitical divides could hinder progress in achieving progress on global challenges faced, including the mitigation of climate change. Similarly, the consequences on power sharing within the Bretton Woods institutions (namely the IMF and the World Bank) and the United Nations are likely to shift to more adequately represent a more representative share of the global economy.

Structural reforms to lift SA's medium-term growth to a 2%-handle

It has been a busy diplomatic year for SA, starting with the country controversially hosting the Russian foreign minister, the SA-Russian-Chinese joint maritime exercise and US ambassador Reuben Brigety's claim that SA had supplied Russia with arms. Although the

Lady R panel report found no evidence that any cargo of weapons was loaded for export on the ship, the damage to the rand has not reversed with other adverse currency factors taking its place, including fears over a China slowdown and lingering concerns over an

economic deceleration due to stringent monetary policy aimed at mitigating lingering inflation fears.

Aside from negative developments in SA's international relations, softening growth in China has led to a dampening of SA's exported commodity prices, which poses risks to SA's growth profile, external imbalances and fiscal dynamics.

SA has been overwhelmed by a spate of bad news and the mood of the country has remained sour, with business confidence and consumer sentiment remaining significantly below their long-term averages. Moribund confidence is not surprising in the context of flat growth in per capita incomes since the GFC, job insecurity, malfunctioning state-owned enterprises and widespread corruption.

In spite of challenging developments in the realm of foreign affairs, SA improved its international standing through hosting a highly productive BRICS Summit and actively engaging at the G20 Summit held in India. In these meetings, SA was able to amplify the voices of the other African nations, participate in promoting the inclusion of the Global South in multilateral systems and further efforts around sustainable development in the spirit of South-South cooperation.

Although structural bottlenecks are likely to cap the growth recovery to 1% next year and 1.7% in the year after, tangible progress on priority reforms which have been identified for their potential impact on economic growth and job creation point to better growth conditions ahead and could provide a healthy platform for a 2% handle on medium-term growth outcomes.

To fast-track the delivery of economic reforms which are at the core of the Economic Reconstruction and Recovery plan (including those that have been delayed or blocked before), a joint initiative between the Presidency and National Treasury was set up to monitor progress and actively support the implementation of these reforms.

Since the launch of Operation Vulindlela in October 2020, a narrow list of focused priorities has been

identified as the main economic levers to achieve the greatest positive impact on growth and employment.

Energy sector reforms under Operation Vulindlela have been aimed at addressing the electricity shortfall, the lack of competition in electricity generation, the inability of government to fund investment in additional generation capacity and the deteriorating quality of municipal electricity distribution services. EE Business Intelligence calculates a strong pipeline of private sector projects to alleviate the growth hit from loadshedding in the medium-term (see table 1).

Table 1: Substantial private sector pipeline of energy projects should alleviate loadshedding

Announced MW	2023	2024	2025	2026
Eskom	0	800	800	0
Public procurement	0	1 430	2 470	4 700
Imports	200	1 000	0	400
Municipalities	0	25	425	700
Private PPAs*	0	630	1 995	3 820
Domestic/commercial	2 000	2 600	3 400	3 600
Total	2 200	6 495	9 090	13 220

Source: EE Business Intelligence

*PPAs = purchasing power agreements

The Minerals Council estimates that there are 3500 trucks per day carrying mined products across the country's roads (double the amount in 2020) as a direct consequence of locomotive shortages and vandalism. With a fall in coal prices, this mode of transport will become increasingly expensive for exporters. The subpar performance of SA's logistics system has resulted in the loss of significant export revenues for the country. The Minerals Council estimates that SA lost around R50 billion in exports of bulk commodities like iron ore and coal in 2022 and around R35 billion the year before. Operation Vulindlela seeks to enhance the efficiency and competitiveness of freight transport and limit lost export revenues. The setting up of a National Logistics Crisis Committee and Freight Logistics Roadmap should expediate this process.

Reforms in the water industry aim to increase investment in the maintenance and construction of water infrastructure as well as to improve water quality. Via the successful reinstatement of water quality monitoring systems, government will ensure that water sources are protected, wastewater treatment plants are functioning and leaks are fixed. Meanwhile, a faster processing of water-use license applications improves the ease of doing business in SA.

Similarly, reforms in the digital communications sector can support higher levels of economic growth by reducing the cost of data over time, expanding internet access to low-income households in outlying areas, driving new investment in telecommunications infrastructure and unlocking gains in the knowledge economy.

Lastly, the successful implementation of the eVisa system and expanding visa waivers to more countries should facilitate growth in the tourism sector. Tourism is a quick and easy way to create jobs for relatively unskilled persons. Growing this industry can establish a strong multiplier effect on the economy given the dependence on the retail and hospitality sectors. Meanwhile, further work is being explored to establish a trusted employer scheme and points-based system to introduce greater flexibility into the visa process to attract skilled workers where there are gaps in the SA economy.

While the private sector is making further headway in assisting government to fix structural bottlenecks in the economy, the wide trust deficit between the private sector and government inhibits the inroads that the private sector can make.

Moreover, flat per capita growth in the SA economy diminishes space for government to support the economy through the fiscus. Austerity in public services spending is eroding the quality and value of public services. Given that painful trade-offs have to be made to drive fiscal consolidation, the risk to sporadic episodes of social unrest remains high, in our view.

Revenue collection outside of corporate income tax has been relatively resilient in spite of consumer headwinds stemming from the cost-of-living crisis and rise in interest rates. Corporate income tax collections have however underperformed expectations on softening commodity prices and a higher cost base owing to costs related to alternative sources of energy.

Growth in government expenditure is also likely to exceed Treasury's February estimates given the higher-than-budgeted for wage increase. Although government has allocated a sizeable contingency reserve to buffer some of the overrun in expenditure on the wage bill and/or a likely extension of the Social Relief of Distress grant, which is meant to end in March 2024, the combination of a sizeable revenue under-shoot and expenditure overrun is likely to see government's fiscal deficit widen by a further 1% to 1.5% over the medium-term framework relative to Treasury's February estimates. This is expected to prevent any meaningful debt stabilisation in the next while, keeping the interest bill high.

Looser fiscal policy places a harsher burden on monetary policymakers to keep policy restrictive for longer to contain inflationary pressures. In a July 2023 lecture hosted by the IMF, the SARB governor noted that we "need to rediscover the dangers of government borrowing" and warned that "responsible policymakers never forget that fiscal debt is risky".

Even though we expect inflation to resume its glidepath toward the 4.5% midpoint of the target band on a more sustainable basis after temporarily higher figures on the back of a retracement in rand oil price, interest rates are likely to stay on hold until the second quarter of 2024 to counter fiscal dominance risks and continued upside risks to the inflation profile posed by loadshedding, drier weather conditions and administered tariffs (including water, rates and electricity). Monetary policy is likely to remain reasonably restrictive to keep inflation expectations at bay and as such we expect up to three interest rate cuts in 2024 to end the year at 7.5% with up to 100 basis points worth of cuts pencilled in for 2025.

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