Q1, 2023
MARKET COMMENTARY

INN8 INVEST

Not so fast – the inflation battle is not yet over.

Over the past decade and a half, central banks have set policy far too loose relative to prevailing economic fundamentals. This is evidenced by the material appreciation in asset prices through excess liquidity, near zero or negative interest rates and quantitative easing. During this time, we know that central banks have been willing to 'pivot' or add stimulus at any sign of a wobble, seeking to minimise economic and market volatility and effectively giving rise to a false equilibrium.

> *"A false equilibrium is a theoretically unstable or unsustainable situation that has been so long lived that it appears to be a true equilibrium." – Iain Cunningham: Co-head of Multi-Asset Growth, Ninety One*

The false equilibrium of the past decade created an obvious imbalance and 'runaway' global inflation has clearly broken the condition required to maintain it. An extended period of complacency and risk-taking throughout the financial markets and economy is now coming to a head as monetary policy makers ramp up rates to get on top of an inflation problem that they were slow to recognise. As a result, we have moved rapidly away from an environment that had become normality and the assumed equilibrium for many.

Resilient economic data suggests that any hoped-for pause in interest rate rises may still be some way off, with the US Federal Reserve, European Central Bank (ECB) and Bank of England (BOE) all continuing to raise interest rates despite the mini-banking fallout.The US Fed raised interest rates at a ninth straight meeting in March by 0.25% to a range of 4.75% to 5%. It indicated there may be more hikes to come in a clear sign that it is confident its bid to quell inflation will not deepen the recent banking fallout.

> *"We are committed to restoring price stability. Inflation pressures continue to run high. Officials are prepared to raise rates higher if needed." – Jay Powell*

Despite the chaos in the banking sector, the ECB raised its deposit rate to 3% from 2.5%, saying that inflation is projected to remain too high for too long.

> *"The ECB will take a 'robust' approach that allows it to respond to inflation risks as needed but also aid financial markets if threats emerge". – Christine Lagarde*

The BOE raised interest rates for an eleventh consecutive time in March. Rates were raised 25 basis points to 4.25%. BOE Governor Andrew Bailey's equivocation at the beginning of March on whether rates should be altered was clearly overtaken by February's shock inflation rise to 10.4% from 10.1%.

Lastly, in South Africa the SARB surprised the market and increased interest rates by another 50bps to 7.75% in March, its ninth hike since the current hiking cycle began in November 2021, as inflation remains sticky. The SARB's stance was decidedly hawkish, which has prompted market speculation that this may not be the end of the hiking cycle. Rate cuts will only come late next year.

Stuck between a rock and a hard place

After the extraordinary events in the US banking sector, central banks find themselves stuck 'between a rock and a hard place' where they must balance their mandate of bringing inflation under control with ensuring financial stability.

The latest interest rate increases suggest central banks remain firmly focused on bringing inflation down, indicating they see rising prices as a bigger growth threat than the bank turmoil. The Fed and authorities stepped in quickly, thus projecting confidence that the economy and financial system remain healthy enough to withstand the bank collapses.

The current US banking turmoil has not been systemic – not yet – and was limited to a few smaller banks in the US. The big question now is whether the turmoil from March will prove to be an isolated incident, or whether it will prove the harbinger of further shocks ahead.

The Credit Suisse 'forced marriage' with UBS is a result of culminating factors over many years and is not related to the same underlying issues that caused a 'run' on smaller US banks. The US episode was not associated with rapid growth in borrowing – such as the 2008 financial crisis – but this time round for a rapid increase in deposits. This speaks to the underlying health in the US economy.

A banking crisis or not? Only time will tell but the one thing we know is that the events of late are expected to weigh on business activity. Banks are likely to become more conservative in lending practices in the near term. This is true in the US and Europe, and possibly beyond. This will do some of the central banks' inflation fighting work for them, potentially limiting the extent of further rate increases to bring down inflation.

SILICON VALLEY BANK (SVB)

Heavily catered towards US tech startups.

As economic conditions for the tech sector became more straitened following the pandemic boom, many of SVB's customers began to draw on their funds to stay afloat. Facing a cash shortage, SVB was forced to sell its bonds at big losses. Spooked depositors had withdrawn enough funds to cause the bank's collapse.

Poor risk management. They invested short-term deposits into long-term bonds. When interest rates rose, the value of the bonds fell, wiping out the equity of the bank. First Citizens Bank agreed to buy most of the assets.

CREDIT SUISSE

Credit Suisse had management changes over the last couple of years. A couple of days before the SVB collapse, Credit Suisse told shareholders that the US SEC had queried its annual report, leading to a delay in its publication.

Furthermore, the Saudi National Bank – one of its largest shareholders – has stated that it will not continue to provide assistance to Credit Suisse.

Although Swiss authorities stepped in to support the bank, it was not enough to calm markets and forced a deal under which UBS will acquire Credit Suisse for almost $3.25 billion. The deal was orchestrated by Swiss regulators.

FIRST REPUBLIC BANK

Eleven of the largest US banks agreed to deposit $30 billion with First Republic to help restore calm. J.P. Morgan, BofA, Citi and Wells Fargo contributed $5 billion of uninsured deposits each, while Goldman and Morgan Stanley each allocated $2.5 billion respectively.

The mass withdrawal was sparked by the fact that 68% of First Republic's deposits were uninsured – meaning they were above the Federal Deposit Insurance Corporation's (FDIC) $250,000 limit – a higher rate than many other regional banks.

SIGNATURE BANK

This is a New York-based lender known for its business with the cryptocurrency sector.

After Silicon Valley Bank failed, depositors became nervous about Signature Bank's health due to its high number of uninsured deposits and its exposure to crypto and other tech-focused lending.

New York Community Bancorp's Flagstar Bank will acquire all deposits and certain loan portfolios from Signature Bank.

BANKS INVOLVED IN RECENT MINI TURMOIL – WHAT HAPPENED

A rollercoaster few months for global markets

Global equities have seen one of the strongest starts to a year on record. This was largely due to the reopening of the Chinese economy and signs that inflation in the world's largest economies were slowing.

The euphoria since settled in the quarter as hawkish rhetoric from global central banks hurt global appetite for risk taking – sticky global inflation forced markets to re-evaluate how high interest rates will need to go and for how long. The ongoing strength in the US labour market – the demand for workers far outstripping supply – is also feeding into the narrative that inflation may not come down as easily as many expect. Jitters about what may unfold in the US banking sector is also weighing on markets.

Despite the market turmoil, the MSCI World Index still managed a 'healthy' 7% return and the Bloomberg Global Aggregate Bond Index, 3%.

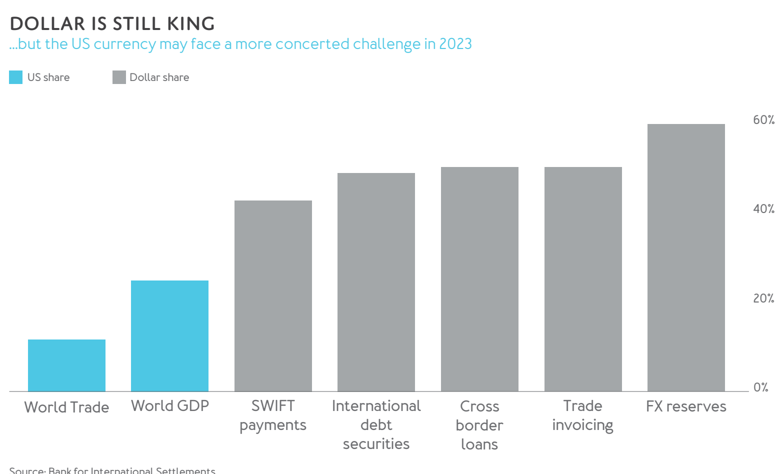
The equity market was led by a very strong quarter from large tech stocks. The Nasdaq Composite Index produced one of its strongest quarters to date – gaining 16% after being down more than 30% in 2022. The gains have been fuelled by their so-called 'safe haven' status as fears of contagion in the banking industry pushed investors toward the cash-rich balance sheets and strong revenue streams of mega caps. Shares such Microsoft (20%), Apple (30%) and Meta (70%) have cemented themselves deeper into society with ongoing innovation and leading-edge technology.

Another tech stock, Alibaba, surprised markets by announcing plans to split its $220 billion empire into six units that will individually raise funds and explore initial public offerings. Alibaba will manage to address two objectives that have eluded many of its rivals – appeasing both a government distrustful of big tech and investors disturbed by the regulatory crackdown. The unbundling of Alibaba presents a template for peers such as Tencent. The Alibaba share price jumped 13% in Q1.

Conversely, banks were one of the weaker performers with the KBW Bank Index falling 18% over the past few months. Having struggled last year, emerging markets saw a much better start to 2023 with the MSCI Emerging Market Index gaining 4.0% and EM bonds up 4.9%.

GLOBAL REPERCUSSIONS OF THE STRONG DOLLAR

After rallying for most of 2022, the dollar's value relative to other currencies has dipped over the past few months. This is probably due to the prospect of the US economy weakening as the US Fed nears the end of the hiking cycle. Despite the dollar's recent weakness, the currency has strengthened sharply against most other currencies over the past two years. The dollar remains king. It is entrenched in everything from central banking to commodity trade and there is no clear alternative.



Unfortunately, a strong dollar is viewed as a major challenge for most countries, especially emerging markets as dollar-denominated debt becomes expensive. Many countries, especially the poorest, cannot borrow the amount or the maturities they desire in their own currency. Lenders are unwilling to assume the risk of being paid back in these volatile currencies. Instead, these countries usually borrow in dollars, promising to repay their debt in dollars.

Did you know?

Only about 10% of SA government debt is foreign currency-denominated, shielding the government from some volatility in debt costs due to fluctuations in our exchange rate.

DOMESTIC CONSUMERS ARE SQUEEZED FROM ALL SIDES

In SA, economic conditions are becoming increasingly unfavourable for the domestic economy. In March, the Reserve Bank revised economic growth downwards to 0.2% for 2023 before raising to 1.0% and 1.1% in 2024 and 2025, with downside risks from load-shedding and logistics constraints. The IMF recently revised its GDP forecast for SA from 1.2% predicted in January, to 0.1%, noting the higher incidence of power cuts, a weaker external environment, and lower commodity prices as reasons for its adjustment.

Headline CPI surprisingly rose 7.0% in February. Excessive price increases of food and non-alcoholic beverages means it could take longer for inflation to approach 4.5%, the midpoint of the target range at which the MPC prefers to anchor

FOOD AND NON-ALCOHOLIC BEVERAGES ANNUAL INFLATION HIT 13.6%, THE HIGHEST LEVEL SINCE APRIL 2009.

THE PRICE OF MAIZE MEAL INCREASED BY ALMOST 35% OVER THE PAST YEAR.

expectations. Sadly, the risks to the inflation outlook remain to the upside due to rising input costs. NERSA granted Eskom the approval to implement a 19% average electricity tariff hike.

It is therefore not surprising to see SA consumer confidence plunges. The latest quarterly Consumer Confidence Index (CCI) that measures the mood of consumers in South Africa, dropped to -23 for the first quarter of 2023, according to FNB and the Bureau for Economic Research. This is the third lowest CCI reading on record since 1994.

RAND HEDGES PROPPED UP LOCAL EQUITIES

SA was unable to escape the global sell-off in February, especially the fall in commodity prices that accompanied the deteriorating sentiment. Commodity markets lost ground in February, pressed by the prospect of rising borrowing costs and reduced global demand.

The benchmark FTSE/JSE All Share Index produced a respectable 5% in Q1 2023. At the main sector level industrials surged 15%, led by the large rand hedge stocks such as Richemont (27%), Prosus (18%) and Naspers (17%). Resources (-5%) proved to be the biggest drag on performance, weighed down by lower metal prices and reduced mining activity due to Eskom's ramped up loadshedding schedule. Anglos fell 12% and Glencore lost 10%. Financials were flat (0.4%) with shares such as FirstRand down 3% and Standard Bank up 3%.

The FTSE/JSE All Bond Index produced 3% for Q1, while listed property, as measured by the FTSE/JSE All Property Index, tracked 4.8% lower. Cash, as measured by the STeFI Call Deposit Index, remained stable at 1.7% for the quarter. The rand has had a tough time of late. It weakened by 5% against the US dollar in Q1 – and more than 20% over the last 12-months. It was the third-worst performing among 23 major EM peers tracked by Bloomberg this year.

OUTLOOK: HIGHER-FOR-LONGER INTEREST RATES

Going into Q2, the global economy will have to face the effect of higher for longer interest rates together with tighter credit conditions on the back of the recent mini-banking turmoil. Though banks are a lot safer now compared to before the 2008 Global Financial Crisis (GFC), there are always risks since the business model is inherently risky. This episode is likely to lead to renewed regulatory scrutiny and so it should. History shows that even relatively short periods of mispricing the cost of money can lead to capital misallocation with households, companies and even governments taking more risk than they should. Tolerance for leverage, duration and illiquidity risk all increase during such periods. We are now beginning to see early signs of businesses that built their operating models around the false equilibrium, are beginning to struggle.

In SA, it is not necessarily the false equilibrium but the knock-on effect of higher interest rates on household spending, as the cost of servicing debt becomes more burdensome. Accordingly, our low growth projections over the next year or two are expected to put pressure on domestic markets. We also saw SA Inc companies come to the market with 'load-shedding' updates, quantifying the substantial additional cost of doing business during rolling blackouts.

STICK TO YOUR INVESTMENT PLAN

With recession a looming concern, global investors unfortunately gravitate towards lower-risk assets. Like investor behaviour in SA, global investors are piling into cash at their fastest pace since the pandemic, unnerved by the bank 'runs', while seeking out higher interest rates at money-market funds. During the first quarter this year, investors poured $508 billion into cash funds. More than $100 billion flocked into money-market funds in the latter part of March alone. Meanwhile, equity funds continued to see outflows, with $5.2 billion of redemptions, according to Bank of America.

The view of many asset managers is that global bonds are starting to offer better opportunities to invest, at attractive prices since the GFC. Global equities continue to play a critical role in a long-term investment plan and their 'expensiveness' is partly a question of time horizon. Earnings across many global sectors are likely to contract this year as margins remain under pressure and the top-line could also start to wain as the economic backdrop softens. Despite the uncertainties – hard landing, soft landing or no landing – investors should not lose sight of the enduring role equities, both local and offshore, play in a well-balanced portfolio. SA equities still appear reasonably priced, particularly on a relative basis.

Moving back to the true equilibrium will result in 'casualties' but it is important for investors to remain patient. Thus, stick to your investment plan and ensure your investments are well diversified between asset classes, strategies and asset managers.

> *"Macro conditions are driving daily market moves, but individual stock fundamentals historically dictate long-term investor outcomes". – BlackRock Asset Management: Equity Market Outlook*

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