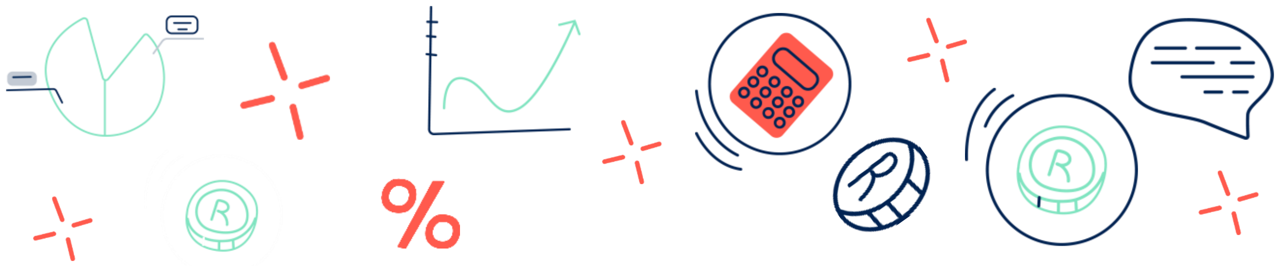
Truffle Asset Management

Economic Commentary

June 2023



The broader US economy is yet to succumb to pressure from higher rates, remaining buoyant through a quarter of sustained tight monetary policy and declining inflation. US equity markets supported strong quarterly performance for developed markets, as the AI theme drove enthusiasm for technology stocks. China's economic recovery has cooled and growth from here is dependent on the level of incremental stimulus from policymakers.

Globally, most major central banks raised interest rates over the quarter as core inflation remains too high vs. Central Bank target levels.

Sentiment in South Africa remained weak, particularly over May, when the Rand reached a low of R19.85 to the USD amidst allegations of arms supply to Russia and a potential Putin visit to SA for the BRICS conference. The economy did, however, gain some respite in June as loadshedding was reduced.

US stronger for longer

US economic resilience continued with market consensus switching to a "soft landing". Q1 GDP was revised up from a previous estimate of 1.3% to 2.0% due to increased consumption estimates. The US Fed may have paused interest rate hikes in June as US inflation comes down, however, the Fed is not yet convinced that further declines to inflation print over the year will be sufficient.

While signals of the increased likelihood of a potential recession in the US have been evident, there are several positive factors that lend credibility to continued economic strength for the remainder of the year. These include:

- US consumers continue to spend excess savings generated during the pandemic.
- Increasing house prices and new builds are evidenced by a strong performance from the homebuilder's index. Higher interest rates have led to supply shortages due to the long-term nature of US mortgage markets and the reluctance of existing homeowners to move and refinance at higher rates. However, this will ultimately result in headwinds for the US consumer.
- Capital expenditure intentions per Fed Surveys are reflecting improvements from current depressed levels. This indicates a potential boost to manufacturing.

The high level of wage inflation (even though marginally declining) and healthy US economy will keep policy rates elevated into 2024 and lessen the probability of a near term recession. However, with 2-year real bond rates at 2.8%, monetary policy is clearly restrictive, and the Fed rhetoric continues to be more hawkish than the sanguine bond market expectations. This is being reflected in a significantly inverted yield curve. Furthermore, tighter lending conditions will place added pressure on the economy. **Given the tight monetary policy conditions and with the economy at full employment, the risk of a recession is significant, even if it might be pushed out to next year.**

US valuations are stretched with the S&P 500 Price Earnings (PE) multiple at 20X. This implies an expectation of robust earnings growth going forward, of an already elevated earnings base. Even using median market PE's (as opposed to the traditional market weighted PE) which are not distorted by high tech valuations, market valuations are at elevated levels relative to history.

Chinese economy spluttering

China's economic recovery following the post pandemic reopening in the last quarter of 2022 has been mixed. Initially, consumer spending trends suggested a stronger comeback, however, recent key industrial indicators are disappointing on the downside with factory output starting to slow. The Economic Surprise indices remain negative indicating actual performance is below economists' expectations.

Stimulus measures including marginal declines to interest rates and bank required reserve ratios, and the extension of tax exemptions on electric vehicles have provided a limited positive impact on Chinese consumption to date. The Chinese Politburo is expected to announce additional measures to stimulate the sluggish economy after a July meeting, however, the nature and quantum of these measures are uncertain. Expectations are for a more balanced approach aimed to boost consumption, support investment, and prevent further deterioration in the property sectors via:

- Monetary policy - a step-up in monetary policy easing.
- Fiscal policy relaxation - new tax breaks and fiscal support on large ticket item consumption.
- Specific property policies - to address funding strains experienced by developers and stimulate demand.

These should go some way to restoring consumer confidence and providing some underpin to the Chinese stock market which is trading on relatively generous valuations.

Given the likely focus on consumption stimulus rather than the historically big, fixed investment rollouts, the impact on commodity prices may well be muted and unfortunate for SA in terms of trade and fiscal budget, which could do with higher commodity prices to boost revenue.

SA: mounting fiscal pressure

South Africa continued to face significant headwinds through the quarter reaching a high point of pessimism amongst market players in May when the Rand lost almost 10% of value in just one month.

Consumer confidence remained low through Q2 slumping to the second lowest level on record since 1994 (Bureau of Economic Research). The post-Covid labour market recovery remains sluggish with non-farm employment still 3% below pre-pandemic levels.

Positively, loadshedding reduced significantly in June as the energy availability factor edged back to 60% on reduced unplanned outages and lower maintenance. If this is sustained it could lead to a near-term upside in the economy.

SA's inflation rate declined over the quarter with CPI prints slowing from 6.8% in April to 6.3% in May. The trajectory is likely to be lower from here, driven by lower fuel and food inflation. Despite the promising trajectory, the Reserve Bank has signaled that rates will likely remain elevated for longer given their determination to get inflation well inside the 3-6% target range. We are hopefully closer to the end of the hiking cycle.

Growing twin deficits weighing on the Rand and SA bonds.

South Africa's fiscal position remains tenuous. The outlook for both SA's trade and budget deficits is worsening with lower commodity prices (especially rhodium and palladium) negatively impacting exports and tax revenue. A higher-than-expected rise in the public-sector wage bill, extension of Covid grants, and further SOE funding also pose an increased risk of expenditure overshoots.

A higher budget deficit will result in a higher bond issuance in 2024, restricting yield compression despite reasonably generous valuations while the higher trade deficit will likely keep the Rand at depressed levels relative to fair value.

Meaningful Chinese stimulus in sectors requiring SA commodities would improve the outlook for SA bonds and currency. Stimulus measures have traditionally involved significant property investment (supportive of commodities), however, as noted above, the nature of any stimulus measures remains unclear.

SA equity markets are trading on low valuations.

Domestically exposed equities are trading on depressed valuations relative to history. Some of which are justified given the concerns highlighted above. In addition, there are risks associated with the outcomes of the upcoming 2024 election which will also weigh on markets.

However, we think there are enough companies trading on suitably cheap valuations that reflect the tough economic environment and which should provide reasonable double-digit returns going forward.

Outlook summary

Several global and local risks continue to weigh on the South African market. A US economic downturn remains likely but may only happen next year. China should introduce further stimulus but the quantum and nature of this remains uncertain. The SA equity market could benefit from this via China exposed shares and possibly through some of its miners.

Locally, small wins such as reduced load-shedding and a respite from political uncertainty should benefit, however, SA's worsening fiscal position poses a risk.

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Morningstar Award was awarded to Truffle Asset Management (Pty) Ltd on 23 March 2022.
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