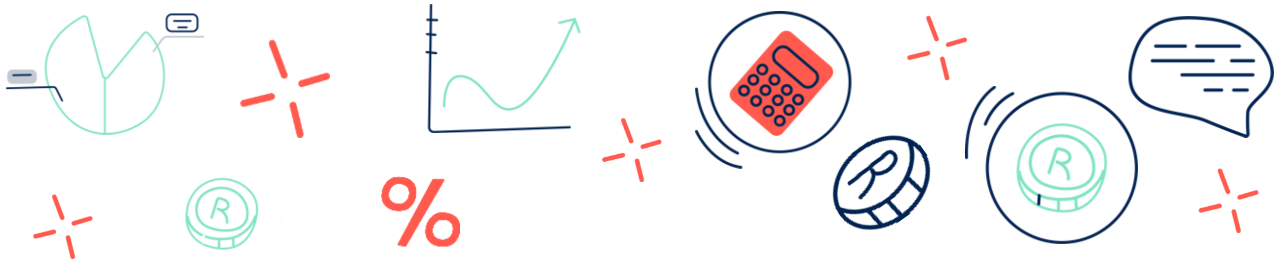
Truffle Asset Management

Economic Commentary
August 2023



Market volatility makes a comeback.

Following a strong July, global markets proved volatile in August and by month end, both Developed and Emerging equity markets had struggled to deliver positive returns. US consumer strength driving economic buoyancy continues to support a higher for longer rates outlook while China's economic data came in weak.

US strength: hawkish Fed

The outlook statement from the US Federal Reserve Jackson Hole economic symposium, clearly indicated that while inflation has been coming down as the post-pandemic economics slowly unwind, restrictive monetary policy will continue to play an important role in bringing inflation sustainably back to 2%. The US economy remains above trend growth – the Atlanta Fed GDP Now model estimates a potential 5.6% GDP growth for Q3 - therefore we can expect higher rates for longer until the economy slows, and employment data begins to soften.

The impact of higher rates will take time to bite consumers given the bulk of US consumer mortgages have been locked in at 30-year fixed rates well below current levels. However, both US and European corporates will start facing higher debt costs next year as significant portions of balance sheet debt will require refinancing at higher rates.

In response to the Fed's hawkish stance, the US 10-year real bond rate rose to a high of 1.87% at month end, a level not surpassed since 2009. The US$ also strengthened against all other currencies given the higher for longer rates outlook.

The S&P500 declined by 1.6% over the month to a forward PE of 20X with some of the big-name tech stocks pulling back over the month. Based on expected US market returns of 3%, and the 1.87% real bond yield, the implied equity risk premium is only slightly above 1%. This bodes poorly for future returns. Furthermore, as consumers exhaust estimated excess savings of US$ 500bn (2% of GDP) as of 31 March 2023, headwinds can be expected for S&P company earnings and GDP growth into 2024.

China challenges weigh on global economy

Policymakers have chosen to implement incremental stimulus measures rather than the aggressive fiscal injections historically seen in China. Interest rates have been marginally lowered and required down-payments for mortgages have been reduced. However, declining home prices and affordability considerations mean consumers are more focused on paying down mortgages rather than buying new homes. Poor sentiment towards the real estate market and a negative credit impulse (the change in new credit issued as a percentage of the gross domestic product) has weighed on Chinese equity market performance.

While Chinese growth remains lackluster and economic activity weak, the modest level of consumer demand and less draconian stance adopted by Chinese regulators in 2023 should be supportive for shares like Tencent that are still generating high single digit revenue growth and have room to increase profit margins.

South Africa: no quick fixes

South Africa's latest inflation print surprised to the downside with a CPI reading of 4.8%. However, food inflation does remain a concern for lower LSM consumer. It's likely we have reached peak policy rates, but the timing of any rate reductions remains uncertain and will follow global movements.

Against a backdrop of significant infrastructure challenges in the country, Transnet's dire 2023 financial results appear to be galvanizing SA government into action to repair the flagging SOE. This would be extremely beneficial for economic growth, budget, and trade deficits given the importance of a robust transport system.

Despite these positive signs, the outlook for government finances remains challenging given lower tax receipts resulting from depressed commodity prices and weak Transnet volumes. The 2024 election may well result in government allowing higher expenditure.

Higher bond yields in August reflect market concerns around government finances and although domestic equity valuations remain low relative to history, the outlook for SA remains murky. The political environment and uncertainties regarding the outcome of the National election next year along with persistent load-shedding continue to weigh on overall sentiment.

The outlook for September remains uncertain as while inflation pressures are lifting, economic risks remain and policy across many markets will remain restrictive.

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

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