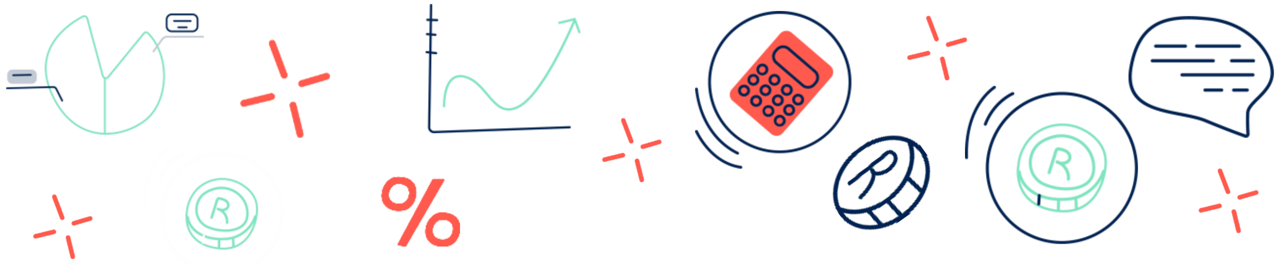

South Africa's progress amidst looming global risks

As we entered the third quarter of 2023, expectations were high for a softer US economy, and markets optimistic that interest rate expectations were close to a peak. Once again, the broader US economy failed to succumb to pressure from higher rates and bond yields have risen further.

China disappointed while South Africa gained a little positive sentiment (off a low base) as remedial actions to drive economic reform became more evident.

US yields accelerate higher

The US economy continues to maintain upward momentum as reflected by a low unemployment rate of 3.8% and a GDPNow forecast of 4.9% for Q3 GDP. While there are some signs of a slowing labour market in terms of lower quit rates and monthly changes in wages below 3%; the high year-on-year wage growth of more than 4%, the higher-than-expected increase in September payroll numbers coupled with a low unemployment rate has resulted in a continued hawkish stance from the US Fed. This has driven real yields on 10-year bonds to well over 2% for the first time since 2009. This has in turn placed upward pressure on the US Dollar and bond yields globally with the SA 10-year rate rising above 12%. The higher long bond rate has pushed the already paltry US equity risk premium lower to circa 0.5% (our expected return for US equities is circa 3% real), further weakening the case for US equity relative to bonds.

Many indicators of US weakness, including depressed manufacturing and a negative credit impulse from tighter lending standards have been offset by a higher government budget deficit, Covid pandemic savings that have yet to be fully spent and a mortgage market that locks in rates for 15-30 years. The latter results in consumers being less impacted by rising rates than would be the case in other countries. However, at some stage homeowners will need to sell and buyers will be forced to pay rates that are more than double those of the last decade. Corporates will also start to feel the pressure of higher finance costs as refinancing starts to pick up in 2024. There has been a shortening of outstanding terms in the high yield debt market as participants wait for rates to fall. The longer rates remain high, the more of a problem this will become. The impact of the lower credit growth from the private sector is yet to be felt and the base of government deficit is already elevated. The US economy is likely to feel pain, but the above factors mean it will be more delayed than in previous cycles.

Expensive US market valuations, especially relative to bonds, are not pricing a slowdown. Given the tight monetary policy conditions and with the economy at near full capacity with limited resources available to fuel further growth, there remains a risk of a slowdown in 2024.

China growth forecasts continue to be revised down

Growth forecasts for China in 2023 & 2024 continue to be revised down as the Chinese economy loses momentum from declining property investment and falling real estate prices. This in turn puts pressure on government revenues from lost land sales and adds to weak consumer sentiment. As a result, Chinese consumers have continued to hold back from spending some of their accumulated savings (which currently equates to approximately 40% of GDP) despite numerous government incentives to boost sentiment in the property sector, as well as cuts to income tax. While these measures are supportive, they will take time to feed through to consumer confidence. Consumers are still feeling vulnerable following the draconian actions during the pandemic years, as well as the subsequent job losses flowing from government policy actions. Other factors contributing to a low level of consumer confidence include heightened geopolitical tension which is further isolating China from the rest of the western world.

The question lingers as to what catalyst is required to shift the Chinese economy into gear with significant uncertainty over China's long-term trajectory and how the economy will continue to grow sustainably albeit at a lower growth rate.

As noted previously, a weaker China does mean commodity prices may remain muted vs. previous economic recoveries which is unfortunate for South Africa and our terms of trade and fiscal deficit.

From an investment perspective, asset prices are cheap. Companies like Tencent have implemented self-help with cost cutting initiatives and are well positioned for an earnings recovery. However, we need to tread with caution given the macro-economic uncertainty and a potential fundamental shift in the Chinese economy.

South Africa: Bottom-up progress in the face of growing global headwinds

South Africa is slowly making progress on domestic reforms. Power generation is improving driven by a combination of the private sector "making a plan" and Eskom slowly attending to operational dysfunction. Transnet, the State's ailing transport and logistics player, has recently announced structural shake-ups which may pave the way for future planned private partnerships. Naturally these reforms will take time to feed into the real economy.

But global risks loom. SA as both an emerging market and commodity-based economy would suffer in the event of a potential US hard landing or with the continuation of a floundering Chinese economy. Whilst certain SA sectors and shares do look attractive and are trading at depressed valuations relative to history, we remain fairly defensively positioned and are building in a high margin of safety given the global uncertainty.

The impact of higher US yields on the SA bond market pushed 10-year yields above 12% and resulted in further rand weakness. With sovereign spreads at reasonable levels and US rates, hopefully, close to peak levels, SA yields should not weaken from current levels.

Outlook: in summary

The Chinese rebound has slowed while the US economy has maintained strength for longer than markets anticipated despite a relatively aggressive rate hiking cycle. The US consumer has been resilient due to mortgage rates being fixed at low levels and having excess savings.

US valuations remain elevated. The strength of the US consumer and an AI theme has driven a re-rating in tech stocks over the year although tempered in the last two months. A combination of stretched valuations and risks to US earnings mean we continue to avoid high allocations to US stocks. We expect that the interest rate hikes seen over the last 18 months will impact the US economy in 2024.

Incremental improvements in the SA economy could have a meaningful impact on growth going forward despite a weakened fiscus. Unfortunately, these wins are counterbalanced by mounting global economic risk and uncertainty. 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. But China's shift in gear is difficult to forecast while growth across developed markets will likely be subdued particularly in regions where household debt is relatively high, and economies are sensitive to extended periods of higher rates.

Our portfolios are defensively positioned with investment in select businesses that display higher margins of safety and strong cashflow yields during uncertain times.

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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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