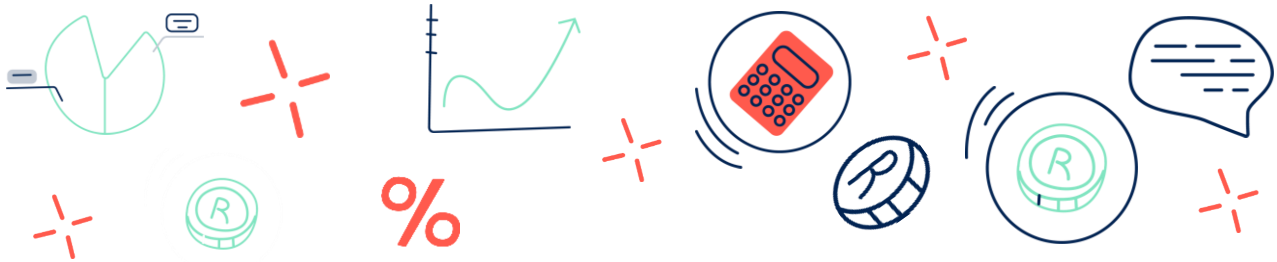
Truffle Asset Management

Economic Commentary
October 2023



Rising geopolitical risks

Weakening market sentiment led global bond and equity markets lower in October given heightened geopolitical risks and expectations that interest rates will stay higher for longer. Energy stocks benefitted, oil in particular, while gold surged as investors retreated to a safe haven.

US reports exceptional growth

October's US economic data once again showed signs of resilience with Q3 GDP at 4.9% quarter on quarter beating market expectations of 4.3% and up from last quarter's 2.1%. A strong build in inventory accounted for 1.3% of growth while robust consumer spending was supported by wage growth.

The narrative from the US Fed once again signaled a higher for longer rate environment with the risk of inflation ticking up again if ignored. While the unemployment rate has marginally weakened, wage inflation is still over 4%.

The higher for longer narrative led 10-year US Treasury yields to spike above 5% in October however slightly weaker than expected US economic data resulted in a significant decline in 10-year yields of approximately 30bps to 4.6% post month end. GDPNow forecasts are currently at 2.1% for Q4 signaling a slowdown for the next quarter.

Equities fell at the prospect of higher rates with the S&P 500 index down 1.2% in October. Earnings revisions on the S&P500 remain marginally negative whilst markets are still highly sensitive to economic data prints and news flow. As noted last month, 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.

Can China deliver sustainable improvements?

China's GDP print also surprised markets to the upside and positively, retail sales increased 5.5% year on year to the end of September. Industrial production, and exports are also improving however the Chinese PMI for manufacturing remains in contractionary territory. It will take time to ascertain if net positive economic news flow is sustainable.

For now, the outlook for China remains uncertain. At best, we can be hopeful that Beijing places a floor under the economy while not stimulating to a point that aggravates macro-economic imbalances including debt and property contributions to the economy.

Heightened geopolitical tensions

The Israel - Hamas war has once again highlighted the fractious state of the world and ever-increasing geopolitical risk environment. There is further risk of a spike in energy prices should other Middle Eastern countries be drawn into the conflict. An investor flight to safety led to higher gold and oil prices over October however the positive impact on oil prices was temporary. Underlying oil demand has been relatively weak and the support for oil given geopolitical risk appears to have waned for now. Global equity valuations do not appear to reflect the increasing geopolitical risk over the last few years when compared to prior decades as seen in limited risk premia.

South Africa's budget update highlights the need for growth.

South Africa continues to face significant economic challenges which were clearly highlighted in Finance Minister, Enoch Godongwana's Medium Term Budget speech on 1 November. Overall, the Budget was marginally ahead of expectations, with a greater focus on fiscal consolidation. Fiscal challenges are to some extent universal as ultimately, with higher real rates in the US, the cost of funding has increased worldwide including South Africa. South Africa will need to generate a primary surplus and/or increase GDP growth to a sustainable rate above 2% to manage its Debt to GDP trajectory.

At this stage it is too early to tell if either of these requirements can be achieved. A primary surplus will most likely require a comprehensive repair and rejuvenation of our ailing SOEs including Transnet and Eskom with significant private sector involvement. Fortunately, there appears to be widespread acceptance of the need for private sector participation in fixing Transnet.

While action plans have been tabled, we are mindful that effective implementation is critical to address the ongoing challenges to SA's fiscal health and fragile infrastructure.

Outlook: in summary

US economic strength persists however signs of slowdown continue to emerge in a market highly sensitive to economic data and news flow. As noted at the end of the third quarter, US valuations remain elevated and 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. Furthermore, increasing geopolitical tensions are dampening any positive outlook for global markets and it appears equity valuations globally are still to price in heightened geopolitical risk that has been building over the last few years.

Acknowledging a weak fiscus, SA's Finance Minister emphasized the need for fiscal consolidation with any economic improvement heavily reliant on the implementation of numerous initiatives including private sector involvement in the repair of Transnet. Although SA growth data has come in above expectations, the country remains heavily hamstrung by poor and weakening infrastructure particularly logistics and power.
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.

Contact

Get in touch with us

Telephone numbers
Johannesburg Office: +27 (0)11 325 0030
Cape Town Office: +27 (0)21 007 0532

Email addresses
General queries: info@truffle.co.za
Institutional services: institutional@truffle.co.za

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