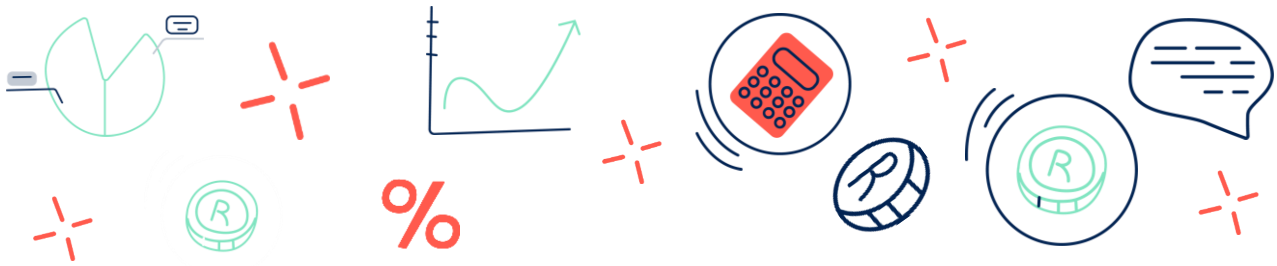
Truffle Asset Management

Economic Commentary
July 2024



SA financial asset prices rebound in July

MSCI South Africa finally played catch up in July to become the best performing equity market rising 5% in USD and significantly outperforming both the broader Emerging Markets Index (-0.1%) and Developed markets. The S&P 500 gained only 1.1% for the month.

By the end of July, the Rand buoyed by the post-election optimism became the second best performing Emerging Market currency, strengthening 2% vs. the USD in the first 7 months of the year.

The July rally resulted in the Capped SWIX, gaining 4.1% (ZAR terms) with outperformance from Resources (RESI 5.5%) largely supported by the Precious Metals sector which was up 12.1%. Financials also delivered strong performance on the back of falling domestic bond yields and SA Banks added 6.1% for the month. SA Bonds (ALBI) added 4% for the month as the yield curve shifted lower and similarly SA listed property was up 4.4%.

.......however global market fear led to early August swings.

A change in sentiment and monetary policy expectations resulted in significant global market fear and dramatic swings in the first few days of August trading. This is largely driven by global market reaction to:

- A shift in growth expectations from the US mega-cap technology counters as earnings underwhelm and valuations are brought back in line with more realistic earnings potential.
- Changes to the US macro narrative, as higher US unemployment data triggers new fear of recession and an increased risk of a hard landing.
- A spike in the Yen and the fast unwinding of carry trades with expectations of a more hawkish Bank of Japan. This intensified market volatility saw a 12% one day fall in the Nikkei on 5 August (the largest one day fall since 1987) which was followed by a 9% gain the day after. These short-term market adjustments are unlikely to impact the global economy longer term, however, demonstrate the impact of changes to short term policy expectations.

US economic activity expected to slow into the second half of the year

Market reaction to sudden fear of a potential US slowdown has been severe and could exacerbate the slowdown if sustained. Despite a relatively robust economic performance from the US economy in the second quarter of 2024 (Q2 GDP up 2.8%) there are signs that the US consumer after a long period of spending post Covid is gradually starting to feel the effects of tighter monetary policy as well as depleted savings. High frequency ISM indicators point to a slowing in the overall economy and a weakening in the US labour market which has been rock solid to date. The July US employment data showed broad-based weakness, jumping to a three-year high of 4.3% from 4.1% in June with both non-farm payrolls and the overall unemployment rate falling short of expectations.

Second quarter earnings from many US companies also revealed a slowdown in consumer activity with a more cautious outlook into the second half of the year.

Despite strong market reaction, we maintain a view that a soft landing in the US is more likely. While the sharp increase in the unemployment rate in July does increase the probability of a recession a large proportion of this higher rate relates to the re-entrance of workers into the labour market rather than broad-based layoffs. We also expect consumer weakness to be buffeted by higher levels of government spending as fiscal deficits are expected to remain above the 7% level. Sudden concerns (or fear) over a sharp US recession appears to be premature and proves the heightened market sensitivity to new data and news flow that will continue to drive volatility in the short term as markets adjust.

We expect US interest rates to be cut in September

Given the weak July data and lower inflation numbers it is almost certain that the Federal Reserve will cut rates in September. Market fears have quickly pivoted away from inflation concerns to growth concerns. Investor anxiety has increased to the extent that the Fed Fund futures are pricing in an 80% chance of a 50bps rate cut in September. Given the Fed's dual mandate of maximum employment and price stability is at risk we expect a September start to rate cuts.

China recovery remains tepid held back by a lack of internal demand

China's economy has leaned on industrial production to maintain growth in 2024 as their property bubble continues to deflate from unsustainable levels. A short-term strategy of stealing final demand from outside China can help bolster the lack of domestic demand however will likely receive harsh response from China's main trading partners. We therefore expect further tariffs and quotas to be imposed on China in the second half of the year as Developed Markets respond to loss of market share in their own industries.

At the same time China continues to be increasingly locked out of key technology necessary to transform their economy and accelerate their productivity over the longer term. Pressure will continue to build for a larger fiscal intervention targeting the weak consumer sector. This may provide a once-off boost to the economy but does not change the most likely outcome of a lower long term growth trajectory for China.

SA rate cut will support short term economic growth

SA inflation is on track to land in the mid-point of the targeted range in the second half of 2024. This together with a backdrop of lower developed market rates should give SARB room to start cutting the local rate. A rate reduction cycle should help the SA economy over the short-term following a sustained period of significant pressure due to infrastructure constraints and more recently election anxiety. We expect SA GDP to recover to within a 1.5-2.0% range by 2025 as infrastructure bottlenecks and power concerns dissipate.

The transition of SA retirement industry regulation to the Two-pot system in the second half is also expected to stimulate short term growth, providing consumers with both relief and support as they opt to draw newly accessible retirement funds to repay debt and increase lifestyle spend.

South Africa's outlook continues to improve incrementally since gaining political and policy stability after the election. Dramatic global market swings at the start of August are indicative of market fears over the extent and timing of short-term policy change and will unsettle investors It remains important to be mindful of short-term noise while distilling the long-term impact of fresh data and news to identify longer term investment opportunities.

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Morningstar Awards were awarded to Truffle Asset Management (Pty) Ltd on 23 March 2022, 22 March 2023, and on 14 March 2024. 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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