

The rate cutting cycle began in earnest

The US commenced their interest-rate cutting cycle with a larger than expected 0.5% cut in September. US bond yields declined, cheered on by an improved inflation outlook and more aggressive rate cut expectations. This led to a weaker dollar, which in turn benefited emerging markets, including a strengthening of the Rand. Global equity markets ended the third quarter around all-time highs, while bonds, credit and commodities managed to deliver positive returns.

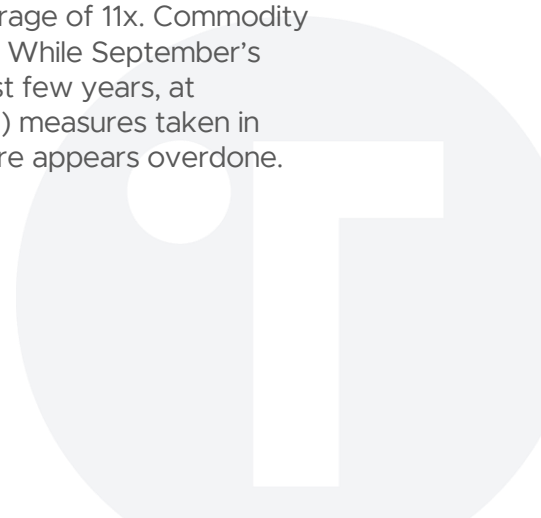
The US economy, while slowing, still remains remarkably resilient as reflected in the GDPNow forecast of 2.5% growth for Q3, and continued health of the labour market. US bond yields are currently discounting a further 175bps of rate cuts over the next year and yields are therefore unlikely to compress meaningfully from here in the near term. Unlike the US, European economic growth remains depressed with PMIs in contractionary territory. This, coupled with falling inflation, has raised expectations of more aggressive European rate cuts driving European bond yields lower.

Whilst the onset of a US recession remains uncertain, the lack of structural systemic issues suggests that any potential recession will most likely be shallow. This, along with significant rate cuts and expected double digit earnings growth, for the short term, is maintaining the high S&P 500 valuation on a PE ratio in excess of 20x. That said, medium-term concerns that could weigh on the US economy remain. Consumer savings rates are historically low and below pre-pandemic levels while government deficits are significantly higher than historic levels, and the debt-to-GDP ratio has surpassed the post-WW2 peak. Against the backdrop of a high fiscal deficit, the next governing party will have their hands tied with respect to tax cuts and spending.

China stimulates again ... but is it enough?

Chinese policymakers announced a package of co-ordinated stimulus measures in late September. These were monetary, fiscal and equity market related and included the easing of monetary policy, the lowering of mortgage rates and the provision of funding to local governments to purchase property. There were also measures to support the stock market.

The Chinese equity market's positive response to the stimulus saw MSCI China's return for the quarter at 24%, bringing its PE ratio in line with its 10-year average of 11x. Commodity prices such as Iron Ore rose almost 20% post the announcement. While September's stimulus measures were more significant than those seen in the last few years, at approximately 1.5% of GDP, these are a fraction of the (successful) measures taken in previous downturns like the one in 2015. Market response therefore appears overdone.



China's depressed consumer confidence continues to weigh on spending. Encouraging banks to lend more does not solve for this. Whilst some of the policies do aim to stimulate consumer confidence, the quantum is insufficient. To date lax monetary policy and lowering interest rates has had negligible impact. Equity market support will also be temporary unless accompanied by a change to the economic outlook.

In addition to what we would consider an overreaction to Chinese stimulus measures, lacklustre global industrial production remains a headwind for commodities. The JPM Global manufacturing PMI deteriorated further to 48.8 in September. However, given the collapse in refining margins which will reduce refined product supply and disappointing mine production, copper should be supported over the next year. Gold will benefit less from falling real rates and the weaker dollar (which supported over the last quarter) and is becoming more reliant on EM central bank purchases.

The Chinese economy remains sluggish as evidenced by lacklustre credit and monetary aggregate growth. Weak internal demand, low consumer confidence and depressed consumer spending are at least being offset by double-digit export growth. However, risks continue to build as we see further tariffs being placed on Chinese exports and continued weakness in the property market weighing on consumer sentiment. Like the US, China's hands are somewhat tied. To make a meaningful impact on their economy, they would need to deploy a level of fiscal stimulus however, this would once again place them on a concerning Debt to GDP trajectory. Unless they can find genuine return accretive projects, this could potentially create financial instability and merely result in a once-off gain. Whilst we think there will be further stimulus measures, the likelihood of these being significant, and real economy-changing, is low.

South Africa's growth outlook improves

The outlook for SA GDP growth over the next year is finally improving. While the consumer remains under pressure, several short-term growth drivers include:

Given the weak Chinese economy, coupled with a sluggish global manufacturing cycle, the risk to bulk commodity prices remains to the downside.

- Interest rate cuts, real wage growth and the introduction of the two-pot retirement reform (Two-pot) which will benefit near term consumer spending and savings. Two-pot, implemented in September, is expected to lift consumption given embattled consumers are opting to immediately withdraw the relevant allowance. An added benefit to tax receipts, this should also help buffer any revenue line shortfall for this fiscal year
- A decline in the oil price and import volumes will benefit GDP and the current account. The fuel price dropped to 2022 lows and will continue to ease inflation. Encouragingly, the recent CPI print came in at 4.4%, well within the target band.
- Home Affairs successfully clearing 50% of the visa backlog with a focus on critical skills and tourist visas.
- A promising increase in tourism numbers. 10% more tourists in a year could add 0.6% to GDP and needs little additional capital.
- The tailwind of reduced loadshedding.

Medium term growth should be supported by additional benefits to energy supply from the renewable pipeline, political stability from the GNU (despite some fightback at some metros in Gauteng) and SOE and structural reform. Transnet Freight Rail recently announced its official split into an infrastructure manager and an operations company, paving the way for third party participation, while the new freight tariffs for the private sector should be finalised by year end. Still to come is the separation of Eskom's transmission network.

Two years of above 2% GDP growth appears to be a reasonable outcome and could well attract foreign investors into SA equity. Furthermore, company earnings expectations do not currently reflect this level of GDP growth.

A lower cost of capital has led to higher valuations of domestically exposed shares, which have meaningfully outperformed since the elections. Domestic equities, including banks and retailers, are now trading in line with their 10-year averages. Absent a significant commodity cycle, further increases in valuations will depend on the necessary economic reform to drive economic activity and growth as noted above. Nonetheless, even at current valuations, the combination of dividends and double-digit earnings growth should deliver strong returns from the domestic equity market over the short term.



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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.

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