Q2 Economic Commentary

AUTHOR: SAUL MILLER & NICOLE AGAR, PORTFOLIO MANAGERS

Markets move on, even as the conflict has not

The conflict in Iran remains unresolved with a fragile ceasefire punctuated by isolated incidents. Markets, however, have largely moved on. The Strait of Hormuz has partially reopened, and while the world is still learning to route around residual disruption, the oil price has retraced as the market once again begins to factor in the medium-term risk of excess supply. The normalisation of refined product availability will take longer, given the time required to repair infrastructure and restore normal flow. Encouragingly, peak inflationary pressure from the conflict appears to be behind us, and fears of more persistent second-round effects have started to subside.

US: Inflation and interest rates

New Fed Chair, Kevin Warsh, moved quickly to establish his independence, opening with a more hawkish tone than markets had expected. As oil prices slumped, he softened this stance, acknowledging that inflation risks had come down, however he has continued to stress a commitment to price stability. The market is currently pricing a little over one more hike this year.

The significant reduction in inflation expectations, as reflected in inflation swaps, alongside retreating oil prices, has pushed short-term real yields up from 1% to a considerably more restrictive 1.8%, effectively tightening monetary policy regardless of what the Fed does next.

The K-shaped economy remains firmly intact. Earnings growth and enthusiasm for AI continue to lift the S&P 500, supporting the wealth effect and spending among higher-income consumers. However, overall consumer confidence remains lacklustre, and the labour market is slightly softer.

Given mixed economic data and monetary policy that has already tightened via the bond market, we think further rate hikes are unlikely. However, given the persistently elevated levels of inflation since the Covid pandemic, the Fed will want clear evidence of a sustained decline before it entertains any cuts. Real long bond rates of 2.3% remain broadly consistent with long-run GDP growth expectations.

The AI story continues to evolve

One of the defining investor questions in AI is how value will ultimately be captured across the value chain. Of the four layers that make up the chain today, semiconductors capture the bulk of gross profit share, while hosting companies (hyperscalers such as Amazon and

Microsoft that rent out compute capacity), foundational large language models (OpenAI, Anthropic) and applications show little value accrual. For the economics to prove sustainable, value extraction will eventually need to migrate upwards to these other layers. We believe that path is likely to remain murky before a more economically rational equilibrium can emerge.

Leading Western large language models face growing competition from open-source alternatives, typically Chinese, which are proving 'good enough' for less complex work at a fraction of the price. This is pressuring pricing and market share at the model layer, with potential knock-on effects for the hyperscalers hosting these Western models. Weaker model economics could translate into softer rental demand and near-term hosting overcapacity, interrupting hyperscaler capital spending and, ultimately, demand at the semiconductor layer.

The picture is further complicated by participants integrating across the chain in both directions. Anthropic and OpenAI are building vertical applications, like Claude for Legal, with ambitions extending into hosting and chip design. The hyperscalers are developing their own AI chips in an effort to erode Nvidia's dominance.

In short, while players across the value chain are encroaching on one another's territory in response to the dynamics within their own layer, the greater risk is that open-source models' ability to pressure Western models and the application layer could compress margins across the chain before value has had the chance to migrate upwards. Pressure on large language model profitability may be a contributing factor to OpenAI's delayed IPO. Given that semiconductor companies are already earning most of the profit in the chain, and given how extremely high their margins are, particularly in memory, the risk to this segment is becoming more of a concern. We continue to see opportunities in select technology companies that have been punished on the perception that they are not optimally positioned for AI, Tencent being one such example.

Commodities: oil downside risk

Over the medium term, the risk for oil is to the downside. Prior to the Iran conflict, there was already concern about excess supply and once countries have rebuilt their inventories, these concerns will likely deepen. Additional supply is coming from low-cost producers such as the UAE, which has now also left OPEC. Its cost of drilling is roughly half of Saudi Arabia's, and it holds an estimated two million barrels of spare capacity.

US shale is now a major driver of the oil price, with an extraction cost of around $65, while renewables and EVs continue to steadily grow their share of the energy mix.

Gold has pulled back from January highs and now sits in a more neutral territory. The long-term drivers behind central banks' continued accumulation of gold should hold, and dollar weakness should provide a modest additional tailwind.

South Africa: lacklustre growth

South Africa's terms of trade remain favourable, with precious metal prices still elevated and the oil price meaningfully lower. The economy is still in a phase of structural disinflation, and the currently elevated cyclical inflation reading should peak soon. This, combined with

fiscal prudence evidenced by a primary surplus, has resulted in a sovereign credit upgrade from Fitch and an upgrade to Moody's credit outlook. This has been positive for the rand and domestic bond yields, both of which should remain supported. This in turn should help underpin South African equity valuations.

Reform momentum continues, with Transnet making tangible progress. Municipalities remain a problem area; the White Paper released in March is promising in intent but carries very long implementation timelines.

South African economic growth unfortunately remains lacklustre, a factor we continue to weigh carefully in our sector positioning. The consumer remains under pressure, and as a result we continue to favour more defensive retailers and banks that stand to benefit from a more buoyant corporate sector.

Conclusion

The market's swift move past the Iran conflict, despite it remaining formally unresolved, is a reminder of how quickly attention rotates to the next pressing question, in this case the evolving economics of the AI stack and a new Fed chair finding his footing. We continue to favour positioning that is not overly reliant on any single narrative resolving in our favour, while using South Africa's improving fiscal and ratings trajectory, and periods of volatility more broadly, to add to compelling opportunities as they arise

AUTHOR

Nicole Agar, (CA) SA | Portfolio Manager & Analyst

Nicole Agar is a senior portfolio manager at Truffle Asset Management with over 25 years of investment experience. She joined Truffle in 2015 and brings extensive expertise across equity research and portfolio management. Nicole is recognised for her disciplined approach and deep research capabilities across South African equities.

AUTHOR

Saul Miller, FFA | Portfolio Manager & Analyst

Saul Miller is a senior portfolio manager at Truffle Asset Management with 27 years of industry experience. Since joining Truffle in 2016, he has played a key role in managing equity and balanced strategies. Saul is known for his strong analytical skill, consistent outperformance, and deep understanding of fundamental equity investing.

Truffle
Asset Management

Disclaimer

info@truffle.co.za | +11 035 7337 | truffle.co.za

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