

## High-water marks

*Old Mutual Wealth Investment Strategist, Izak Odendaal*

Almost two years' worth of rain fell in Dubai last week, flooding a desert city completely unprepared for such a deluge. It is symbolic of a world under threat from climate change and extreme weather, but also a reminder that surprising things happen in surprising places (sadly, the recent flooding in KZN is not that unusual). Although Dubai's physical infrastructure could not cope with the water, its social infrastructure seemed to manage quite well.

Elsewhere in the Middle East, another unwelcome surprise was Iran and Israel firing missiles at one another in what might still be a dangerous escalation of not only the current conflict, but the long-standing feud between the two countries. However, in both instances, the attacks seemed designed to send a message, rather than cause damage. The price of Brent crude did not rise much above \$90 dollars, a sign that oil traders still see the conflict as contained. Iran is a major oil producer and can interrupt oil supplies elsewhere as about a fifth of global oil is transported through the Strait of Hormuz, a narrow channel it could partially close.

A regional war in the Middle East could easily see oil jump above \$100 per barrel, feeding into global inflation and slowing economic growth. However, unlike Russia, which started its war on Ukraine with a strong economy, ample foreign exchange reserves and supportive population, Iran has none of those. Despite its oil wealth, its economy is already very weak, hobbled by years of sanctions, with inflation of 40% and a currency trading at record lows on the black market (the official exchange rate is fixed by the government). Combined with repressive laws, this does not make for a happy population. This should hopefully limit Tehran's appetite for open warfare. In turn, Israel's allies in the West have urged restraint.

Markets generally struggle to price in the geopolitical risks that often have binary outcomes – there is or isn't a war. But these risks also usually have a limited impact on long-term returns and asset allocation decisions. What really matters is the global economic growth outlook and interest rate cycle. And when we say global, in practice we mean the US. The biggest thing equity investors should fear is a global recession that is centred on the US. Such an outcome has historically been associated with major equity bear markets. Everything else is just volatility, corrections rather than crashes, a torrent that clears up when the clouds lift. As for the interest rate cycle, which is the main driver of bond market returns, we've seen substantial shifts in expectations over the past few weeks.

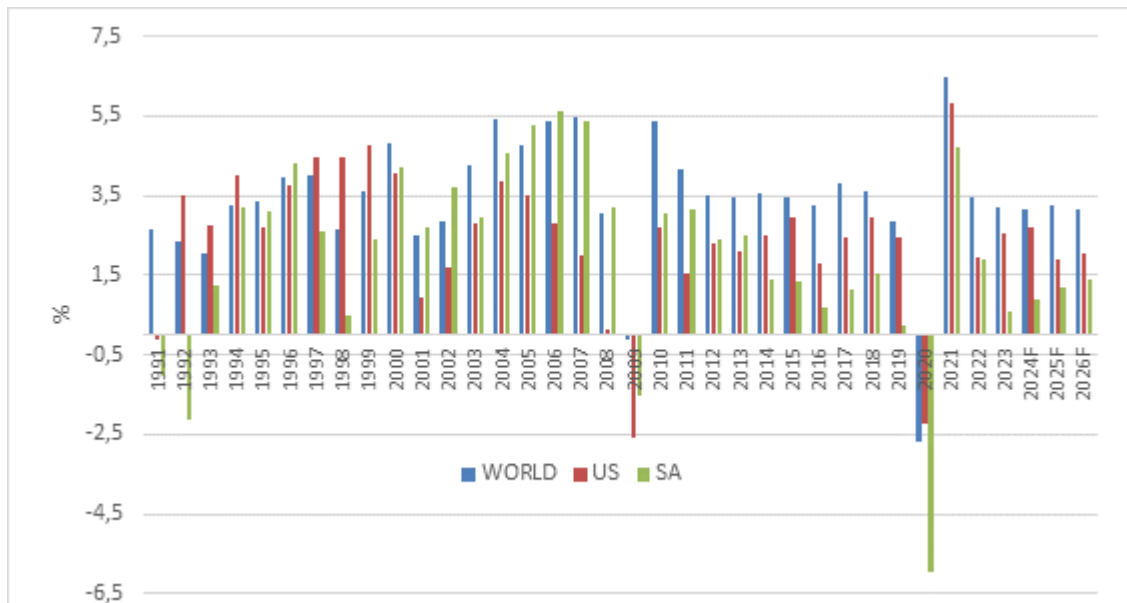
### *The good news and the bad news*

There is good news and bad news on the global growth. The International Monetary Fund's (IMF's) latest bi-annual global projections point to the weakest medium-term outlook in 30 years, with average growth of 3% expected until 2028. This is largely the result of ageing populations in developed countries, while China's era of rapid growth is over (better-than-expected first quarter growth notwithstanding). China's contribution to global growth is therefore fading, while India is not quite big enough to offset it. Another major headwind to global growth, according to the IMF, is global fragmentation and increased trade frictions. Emerging artificial intelligence and robotics technologies might counteract this trend, but we simply don't know yet.

However, in the shorter term, the global economy has been remarkably resilient despite interest rates at multi-decade highs and the persistence of the various geopolitical risks.

The IMF expects steady growth of 3.2% this year. The US is the main contributor to this improved outlook, with the IMF expecting it to grow 2.5% this year, faster than last year, and significantly faster than what was projected a few months ago.

**Chart 1: Global economic growth with forecasts**



**Source: International Monetary Fund**

The wrinkle in the tale, of course, is that strong US growth is seemingly leading to sustained upward pressure on inflation, particularly of services prices. Inflation fell rapidly from the mid-2022 peak without a concomitant rise in unemployment, but the decline seems to have stalled this year.

The flood of rate cuts expected by the market this year has therefore been pared back to a trickle. Bond yields have risen substantially since January. The equity market seemed unfazed at first, but reality sunk in over the last few days. All else equal, higher bond yields should put downward pressure on price: earnings multiples.

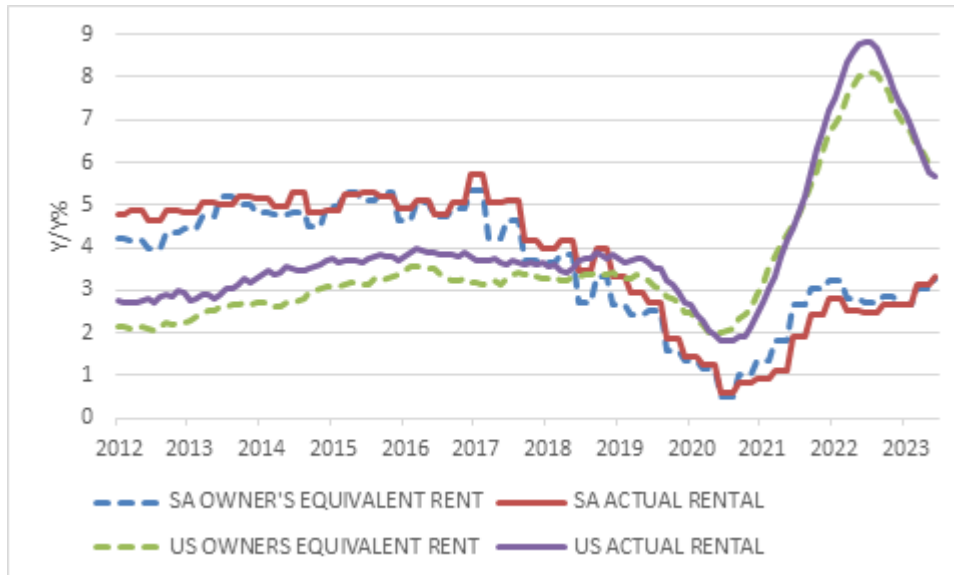
Some are now asking whether the Federal Reserve will be forced to hike rates, an outcome that would really cause stormy markets. This still seems very unlikely unless there was a meaningful and broad-based acceleration in inflation and wage growth. The inflation surprise of the past three months has mostly come from a handful of items (housing and car insurance) while wage growth has cooled.

Since there are lags between changes in interest rates and the direction of inflation, central banks do not need to wait for inflation to be at target to cut rates. However, they do need confidence that inflation is heading in the right direction and will remain on target once it gets there. The current environment means such confidence is in short supply. Fed Chair Jerome Powell admitted as much last week, saying that it will likely take "longer than expected" to achieve that confidence.

Powell's lack of confidence robs many other central bankers of theirs. The SA Reserve Bank doesn't have to wait for Fed cuts before it starts lowering the repo rate, but it needs to have a certain degree of clarity around the Fed's intentions, and of course, it also needs to be sure that local inflation is moving in the right direction.

South African inflation declined to 5.3% year-on-year in March, helped by food prices rising at a slower pace. Rental inflation, a large component of the consumer price index, which is measured quarterly in South Africa, remains subdued. Whereas in the US, rental inflation (including the implied rent homeowners pay themselves – owners’ equivalent rent) has been a major reason why inflation has remained so elevated, in South Africa it is the opposite. The housing category has been a drag on overall inflation, running below the 4.5% mid-point of the Reserve Bank’s inflation target since mid-2018.

**Chart 2: Housing inflation in SA and the US**



**Source: LSEG Datastream**

Though rental inflation has been creeping higher, it is indicative of ongoing weak consumer demand. Although there is a massive housing shortage in South African cities, the demand is greatest among very low-income households with limited means to rent in the formal sector. Among the working population who do rent in the formal market, intense financial pressures mean landlords have been unable to raise rents meaningfully in recent years, with the Western Cape being somewhat of an exception.

What are the implications for local interest rates? As long global oil and food prices remain well behaved, and the rand doesn’t fall further (it already looks weak), the worst of the inflation increase is behind us and it should drift towards target in the months ahead. Rate cuts should follow, but again the question is when and more importantly, by how much.

The local election is a potential factor. The scheduled 30 May Monetary Policy Committee (MPC) meeting will occur before the election results are finalised, and there could be some market volatility as investors await the outcome. The MPC might decide that it is an inopportune time to change policy. This points to a July rate cut, with two or three cuts following over the subsequent months, depending as always on how the outlook evolves.

The Fed’s timeline is also somewhat complicated by the US election. It will want to avoid any possibility of being seen to influence the election outcome, which may make it reluctant to start a cutting cycle too close to the November poll. But if it waits until after

the election, that might also be interpreted as a political statement. No one said setting monetary policy was straightforward!

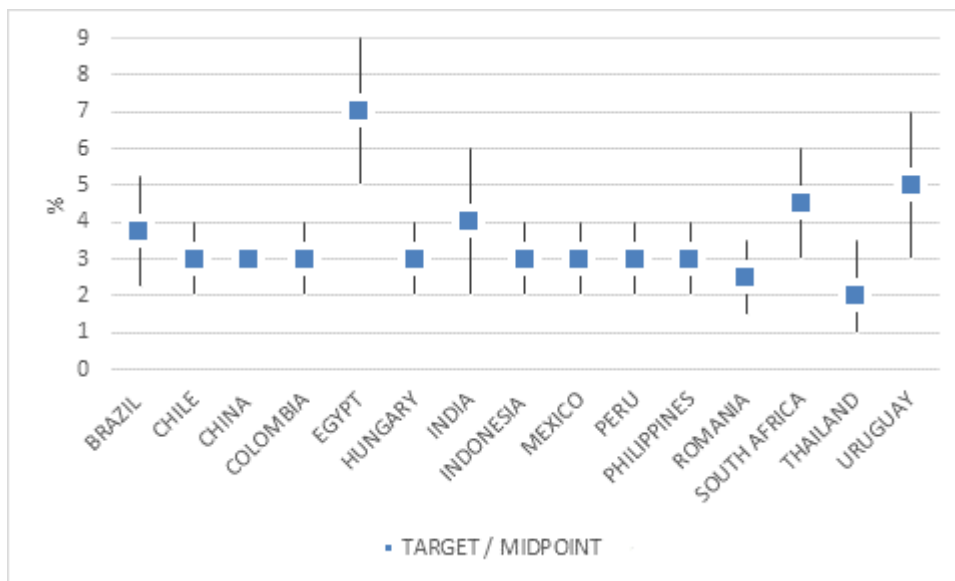
Longer-term thinking also comes into play. Reserve Bank governor Lesetja Kganyago recently reiterated his call for a lower inflation target, saying that discussions in this regard were underway with National Treasury. It is the government that sets the inflation target, while the Reserve Bank must implement it with full independence and discretion.

Lower inflation in the long run will improve South Africa's competitiveness and result in lower interest rates. It should also limit the rand's decline over time, since its performance against hard currencies such as the dollar and pound is largely explained by higher inflation in South Africa compared to the US and UK.

However, getting to a lower target or target range - a range of 2% to 4% with a midpoint of 3% will put South Africa in line with most of its peers, as chart 3 shows - it might require some short-term pain for long term gain. Interest rates could remain at relatively elevated levels to guide inflation down to not just 5% but eventually towards 3%.

This is not cast in stone, and the Reserve Bank is unlikely to be reckless adjusting to a new target. Interest rates are already high for a weak economy, and the Bank will need to proceed carefully and gradually. However, lower long-term inflation is the clear intention of the current leadership of the Bank that will remain in office until at least 2029.

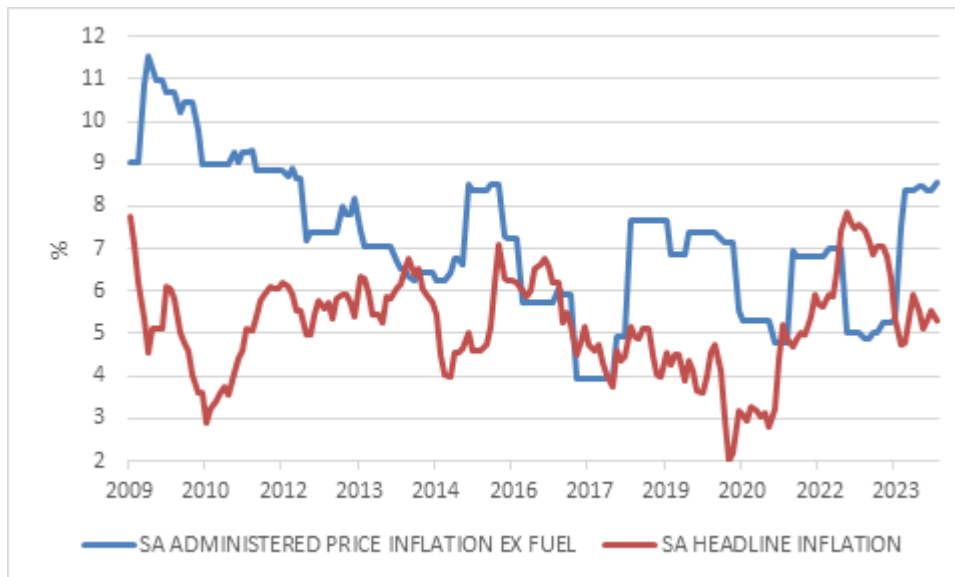
**Chart 3: Inflation targets and ranges, selected emerging markets**



Source: [www.centralbanknews.info](http://www.centralbanknews.info)

The irony is that while the government sets the inflation target, it has probably been the biggest culprit in not adhering to it. Administered inflation has run well ahead of headline consumer inflation over the past decade, with particularly steep annual upward adjustments in electricity tariffs and municipal charges. The government has also given generous above-inflation wage and salary increases to its workers over the past decade. Meanwhile, government inefficiencies, especially local government, substantially raises the cost of doing business. A renewed commitment across government entities to adhere to its own inflation target will go a long way to achieving it.

**Chart 4: SA Inflation**



**Source: StatsSA**

From an asset allocation point of view, the one thing we can say about the seemingly upside-down world we live in is that interest rates worldwide are higher than in recent years and seem unlikely to recede dramatically, a new high-water mark of sorts. If rates do decline significantly, it seems more likely to be because something will have gone wrong (recession) than right (substantially lower inflation). This provides a different set of opportunities than the TINA (There is No Alternative to equities) era after the global financial crisis and pre-Covid.

Finally, while weather forecasts are usually quite accurate, and flood warnings can save lives, economic and market forecasts are often wrong. It is very risky to bet the farm on them. They can be useful to guide thinking about different scenarios, but portfolios should be appropriately diversified to perform well under all outcomes.