

Midpoint musings

Old Mutual Wealth Investment Strategist, Izak Odendaal

At the midpoint of an eventful year, what does the investment landscape look like? Though there will always be some areas of weakness and lurking risks, broadly speaking, the environment seems positive. Known risks tend to occupy investor's minds and are therefore also largely discounted in markets. It is the unknown or surprise outcomes that cause real market volatility. The string of recent unexpected election outcomes is a case in point. While it was common knowledge that France has high government debt levels and a rising political right, few worried about it until the prospect of a populist government suddenly emerged following President Macron's unexpected calling of a snap election.

Getting to grips

The most important thing for investors, however, is the global growth, inflation and policy picture. More precisely, it is the United States (US) outlook that matters most, given that it makes up a fifth of the global economy but more than half of global financial markets. Other major economies – Europe, China, Japan – are not irrelevant, the US just counts for more.

At a high level, US growth is still solid, and indeed its performance has been remarkable. As the International Monetary Fund (IMF) pointed out last week, the US is the only G20 economy that is bigger than what the pre-pandemic trend would have predicted. The others have mostly recovered Covid-related losses but are still smaller than they would have been had there been no pandemic.

American consumers continue to benefit from rising real incomes as a tight labour market supports wage growth while declining inflation means those dollars can buy a bit more than before.

This doesn't mean that everyone is happy. Though inflation (the rate of change of prices) is down from a peak of 7% to around 3% today, the price level is more than 20% higher than before the pandemic. Goods and services cost much more than before, and this matters more to the Average Joe than economists rambling on about lower inflation.

Chart 1: US inflation



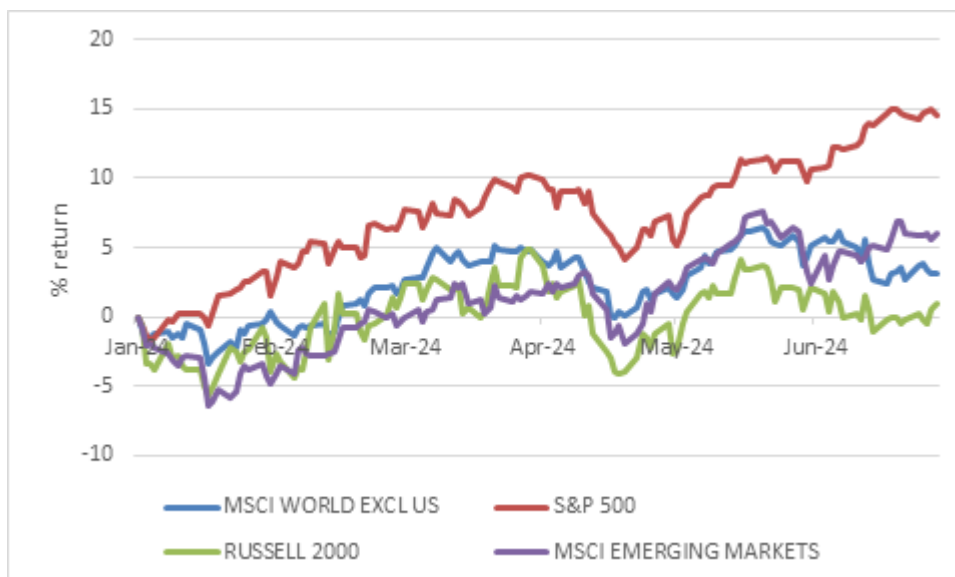
Source: LSEG Datastream

Moreover, there is a distinction between haves and have-nots. People who own assets such as houses and equity portfolios have seen these appreciate in value. Overall household net wealth (assets minus debt) is near record levels. Since mortgage rates tend to be fixed, most homeowners are unaffected by the surge in interest rates. On the other hand, people who don't own a home have not only missed out on rising house prices but are also forced to rent in a market where rentals have surged. Those who were hoping to buy a house have been locked out by the combination of high interest rates and high house prices that has left housing affordability at record low levels.

It means that housing activity, one of the US economy's key cyclical sectors, is running unusually low. In other words, though the overall economy is resilient, high rates are clearly squeezing certain areas. This includes durable goods orders, which are not growing, while the problems in commercial real estate are well known. Another area is small business. Many large businesses could lock in low interest rates by issuing bonds. Smaller firms rely on banks and often pay variable rates. High interest rates hurt them, as do rising staff costs. If sales growth starts cooling, many could face problems.

So, while the S&P500 has had a good first half of the year, driven mostly by a handful of large technology companies, the small cap Russell 2000 index has moved sideways. Outside the US, developed markets are positive for the year, but lag the S&P500. Ditto for emerging markets. This is partly a dollar story, with the trade weighted dollar index 4% higher in the first half.

Chart 2: Global equities in 2024 in US dollars



Source: LSEG Datastream

The outlook for the dollar is important as we move in the second half of 2024 and beyond. A weaker dollar would not only boost reported returns from outside the US, but also relieve pressure on the global financial system and commercial activity. Since capital tends to go to where interest rates are highest, adjusted for risk, much depends on where US interest rates settle. Developed market central banks in Canada, Switzerland,

Sweden and the European Central Bank have started cutting rates. Japan is raising rates, but by such small amounts that it barely counts, and the yen continues to fall. Several emerging market central banks are already deep into a cutting cycle.

With US growth still solid, the labour market tight and service inflation looking sticky, the Federal Reserve lags its peers by keeping rates elevated. But the conditions that gave rise to the 5.5% level of the Fed's policy rate no longer exist, and it is justified in lowering rates somewhat. As noted above, pockets of the US economy are crying out for interest rate relief, and the Fed would be taking an unnecessary risk in ignoring them.

This could ease upward pressure on the dollar, but it remains likely that rates will settle well above the pre-pandemic level.

Gnailbiting GNU

For South Africa, the first half of 2024 has been a particularly eventful. The country sailed into uncharted political waters in the May election, with the ANC not only losing its majority for the first time in 30 years but doing much worse than expected. This outcome caused great unease, but three important things did not happen. Firstly, the ANC did not dispute the results. It accepted them without question and started coalition talks. Secondly, President Ramaphosa did not lose his position, as many expected would happen given such a dire electoral performance. Therefore, there will be broad continuity in leadership and policy. Thirdly, the resulting coalition government did not shift in a populist or leftist direction. Instead, a centrist Government of National Unity has emerged.

Whether it lasts is another matter. Coalition politics at the national level is new to South Africa, and there have been teething problems, including testy negotiations over Cabinet positions, which were finally settled over the weekend. And while the GNU includes parties that have long opposed one another and disagree deeply over some issues, it is based on a set of core principles that all parties recognise. Importantly, these include respect for the Constitution (which includes property rights), the need for faster economic growth and social upliftment, evidence based (as opposed to ideological) policymaking, and the establishment of an impartial and professional civil service. The importance of the last point cannot be overstated. Getting the right people in the right positions is crucial.

There needn't be too much reinvention of the wheel. Many important reforms were already underway before the election and just need to be cemented. Notably, Operation Vulindlela, the joint initiative between Treasury and the Presidency set up in 2020 will continue its work of tackling a focused list of obstacles that impede economic growth. It has already achieved success, notably in deregulating the electricity sector.

Fiscal consolidation is also something that has been underway for some time and should continue, though the exact contours could shift somewhat under the new coalition. The retention of Enoch Godongwana in the role of finance minister is a good starting point. Encouragingly, there is already some evidence of progress, as the government posted a small primary budget surplus in the 2023/24 fiscal year. This means tax revenue exceeded non-interest spending for the first time in 15 years. This is a key step towards bending the trajectory of public debt, which stood at R5.2 trillion (75% of GDP) at the end of the first quarter.

Policy, not politics

In other words, while the politics could be messy and uncertain, economic policy is still likely to move in the right direction, if gradually and unevenly so, raising the medium-term growth profile of the economy. In turn, this should support South African asset classes even if political events cause volatility, as has been the case over the past month.

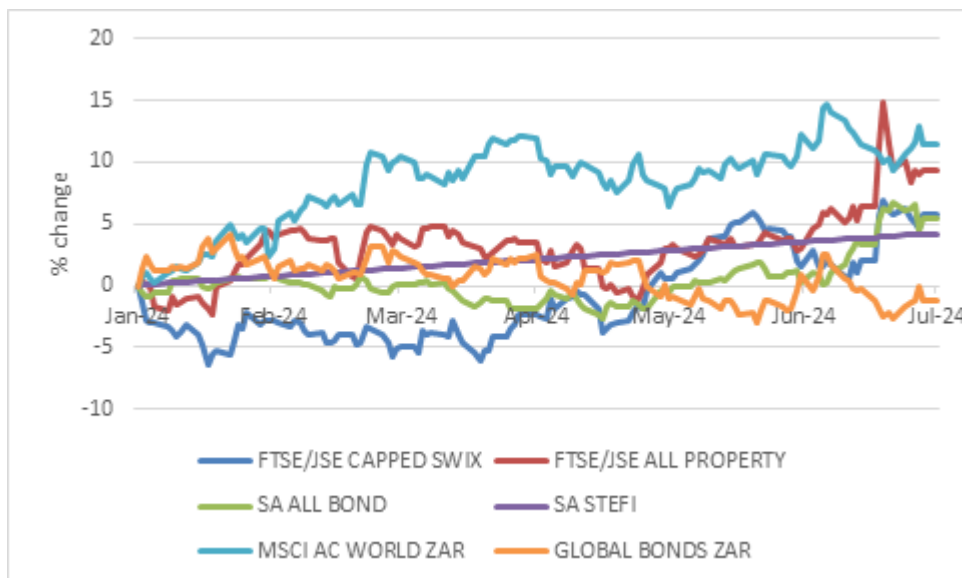
A further, modest boost is set to come from lower short-term interest rates. Inflation is likely to return to the 4.5% midpoint of the target range early next year. Failing some global calamity that sends food or fuel prices skyrocketing, inflation should remain under control given soggy domestic demand and gradual easing of the supply-side pressures on prices (such as firms having to run generators during loadshedding).

There is also little inflationary pressure from the labour market, as the Reserve Bank reported unit labour costs growth (wage growth adjusted for productivity) of only 3% year-on-year in the first quarter.

As in the rest of the world, local interest rates are not likely to fall much, but the more the government can deliver on reforms, the more room for positive surprise there will be. In most situations, stronger economic growth means higher rates, but in South Africa's case, persistently disappointing growth puts upward pressure on rates by raising the risk premium. The more the risk premium declines, the more rates can fall.

Consumers could use interest rate relief. The latest Reserve Bank data shows that interest payments are taking an increasing share of household disposal income, though at 9.2%, it is not high by historical standards. Since 1994, this ratio has had a low of 7% and a high of 13%. The ratio of debt to income ticked up to 63% but remains well below the 78% record level of early 2008.

Chart 4: SA asset class returns in rand, %



Source: LSEG Datastream

From a return point of view, it has been a good half-year, despite all the political and geopolitical drama at home and abroad. The leader among the traditional asset classes

available to South African investors remains global equities, though the rand-dollar exchange rate is largely unchanged year-to-date.

South African listed property has been the surprise star this year, returning 8% and reminding us all that for a battered asset class to jump, the news needn't be good, it must just not be as bad as expected.

Equities and bonds delivered a similar first-half performance, around 5%, slightly ahead of cash. Looking ahead, returns from money market funds are likely to decline somewhat as the Reserve Bank starts cutting rates, but this should support bonds and interest rate-sensitive equities. The more economic conditions improve, the more these asset classes can benefit since valuations remain attractive compared to history and to other emerging markets, and still offer the potential of above-average returns in the years ahead.

Concluding thoughts

South African investors have had to endure a rollercoaster of emotions in the past few weeks. First the election surprise and ensuing uncertainty, then the excitement of an ANC-DA tie up, perceived as market-friendly, then touch-and-go talks over Cabinet positions. It is worth reiterating three points. Firstly, South Africa's democracy has emerged stronger from this episode, which is ultimately good for its longer-term economic prospects. Secondly, messy politics will be part of our lives from now on, since it seems unlikely that any party will be able to dominate the way the ANC did over the past thirty years. This means parties will have to compromise, and voters will not always get what they want. But it also means that extreme political outcomes are unlikely. The focus of investors should be on economic policy, and this is likely to keep moving in the right direction. Thirdly, for South African investors, the global environment will always matter. As much as we can get lost in local political soap operas, the decisions of international policymakers and institutional investors usually have a bigger impact on your returns.

The real value unlock will probably only happen when there is evidence of faster growth, better governance, and debt sustainability. And of course, a conducive global climate. In other words, whatever happens in the next week, good or bad, will not be the end of the story. Investors will still need to remain calm and be patient.