

Charting the turning points

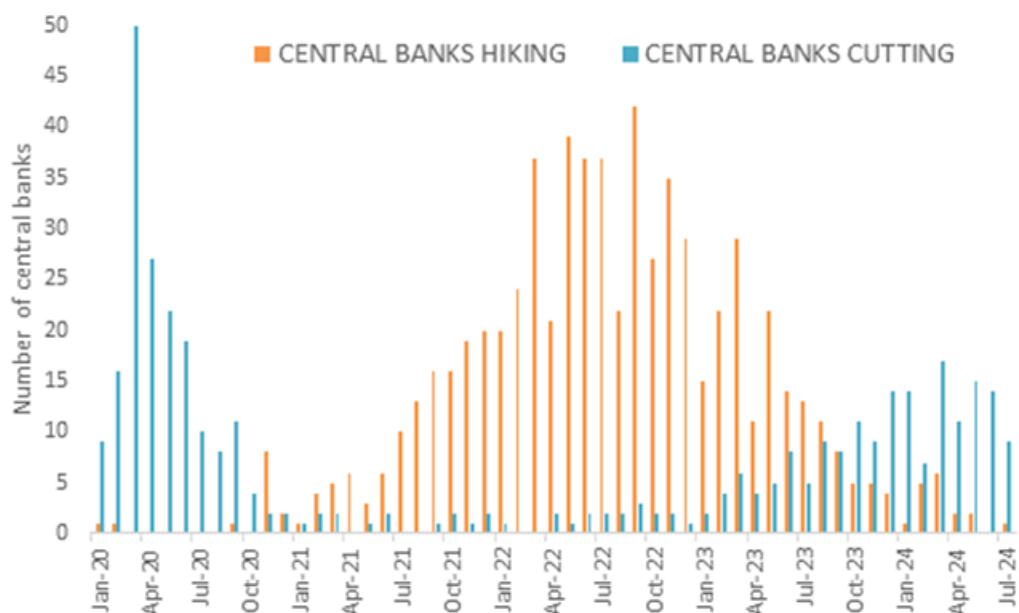
Old Mutual Wealth Investment Strategist, Izak Odendaal

Markets, politics, economics, sport and life. Things are never static. Headwinds become tailwinds or vice versa. Leaders become losers; laggards become victors. There are some notable changes underway, and there are areas where changes lurk, but it is too soon to tell for sure. But there are also areas of frustrating inertia, such as the wars in Gaza, Ukraine, Sudan and elsewhere that show no sign of ending.

One example of change is from the US presidential race, where in the space of two weeks, we've gone from a near-inevitable Donald Trump victory against Joe Biden to a much tighter contest between Trump and Kamala Harris. If this was a spectator sport, viewers would be inching closer to the edge of their seats. But this is unlikely to be the last twist in a campaign that still has four months to run.

From a purely investment point of view, the most important turning point is that of the global interest rate cycle. As chart 1 shows, most central banks are now in cutting mode, with only a few outliers hiking (Nigeria and Russia were the only hikers in the month of July, while nine central banks cut rates). As rates decline, there is relief for indebted households and businesses, while new borrowing becomes cheaper, supporting both capital and consumption spending. As for financial markets, all else being equal, lower rates support higher equity and bond valuations. The important caveat is that rates can fall for good and bad reasons. Lower rates in response to lower inflation is positive for markets, but not if rates are cut in response to an economic contraction. Fortunately, unlike in 2020, the current cycle is largely a case of the former.

Chart 1: Central bank interest rate changes



Source: [cbrates.com](https://www.cbrates.com)

Source: [cbrates.com](https://www.cbrates.com)

The most important central bank, the US Federal Reserve, is unlikely to cut this week, but should start laying the groundwork to start easing in September. US inflation continues to move lower gradually, and while some categories remain elevated, it is never the case that the prices of items in the basket rise and fall at the same pace or even the same time. The Fed's preferred inflation measure, core personal consumption expenditure deflation (PCE) was 2.6% in June.

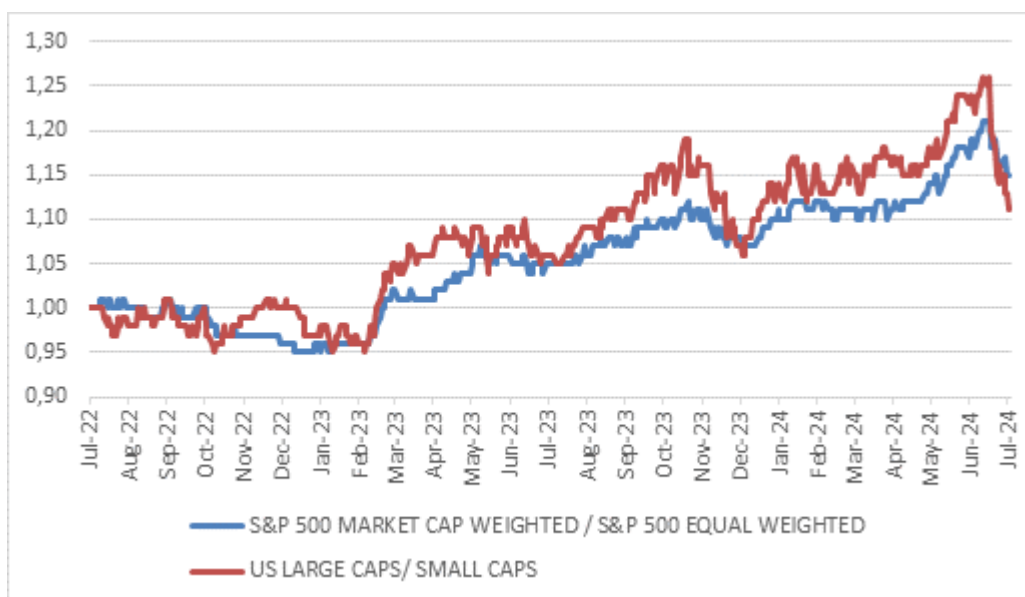
It is not at the 2% target yet, but is moving in that direction. As the Canadian ice hockey legend Wayne Gretzky (aka "The Great One") famously said, 'you stake to where the puck is going' and not where it is now. Similarly, central banks need to make policy today for what the economy will look like 12 or so months down the line. This is because it takes time for interest rates to impact the economy.

The US labour market is cooling, and this means it is unlikely to be a source of upward inflation pressure. Importantly though, the pace of jobs and wage growth remains sufficient to support consumer spending, even if it grows at a slower pace. This all suggests a soft landing is underway.

The Fed (and other central banks) are unlikely to launch into aggressive rate cuts, however, there will be lingering concerns that inflation could flare up again. They will be wary of declaring victory too quickly. For one thing, global supply chains are still very tightly wound and subject to disruptions. The recent global IT outage grounded several large airlines and was a foretaste of what could go wrong, though it was thankfully brief.

Therefore, it is likely to be a modest interest rate cutting cycle, unless there is a sharp slowdown in which case rates will be reduced quickly. The good news is that there is substantial room to cut rates and provide support should this be necessary. It is unlikely that inflation fears will prevent a response to recessionary conditions, which was not the case 12 to 24 months ago.

Chart 2: US equities relative performance



Source: LSEG Datastream

Big to small

When it comes to the equity market, there have been rumblings of turning points too. The market has been led by mega tech shares, the famed Magnificent Seven, until recently. The past two weeks have seen this trend pause, but is it reversing? Unfortunately, we'll probably only know after the fact if this was merely a correction or indeed a turning point.

After such a strong run, a pull-back was always likely, especially since valuations became stretched. If there is any news that challenges the perfect scenario that gets priced in – even if the news is good but not good enough – markets can quickly reprice.

Interestingly though, it is not just that the Magnificent Seven stocks are down 12% from the recent peak, but less favoured small US cap stocks have rallied 8% over the same period. The jump in small cap shares coincides with the growing conviction that rate cuts are around the corner (but often a big move like this is a “short squeeze,” where some leveraged investors were incorrectly positioned and need to quickly unwind their trades.

A lower rates outlook helps stragglers who tend to have lower cash holdings and higher debt levels, which smaller companies typically do. These companies are also reliant on supportive economic conditions, whereas the tech giants have been riding secular trends that make them less exposed to the economic cycle. Artificial intelligence (AI) is the latest such trend, though there is still great uncertainty as to whether it represents evolution or revolution for global productivity, and who exactly the winners and losers will be.

And since we don't know the answer, a diversified approach remains prudent. What we do know is that, historically, returns from elevated valuation levels have been muted, which argues that a repeat of the massive outperformance of the US against other countries and particularly of tech versus other sectors is unlikely to repeat, unless AI is truly revolutionary. Over the past decade, the S&P 500 has beaten non-US global equities by 8% per year in dollars. Meanwhile, the tech-heavy NASDAQ outperformed the S&P 500 by 5% per year. Part of this outperformance is superior earnings growth, but the forward price: earnings multiple of US stocks also rose by 50% more than non-US markets.

Rates ready to roll

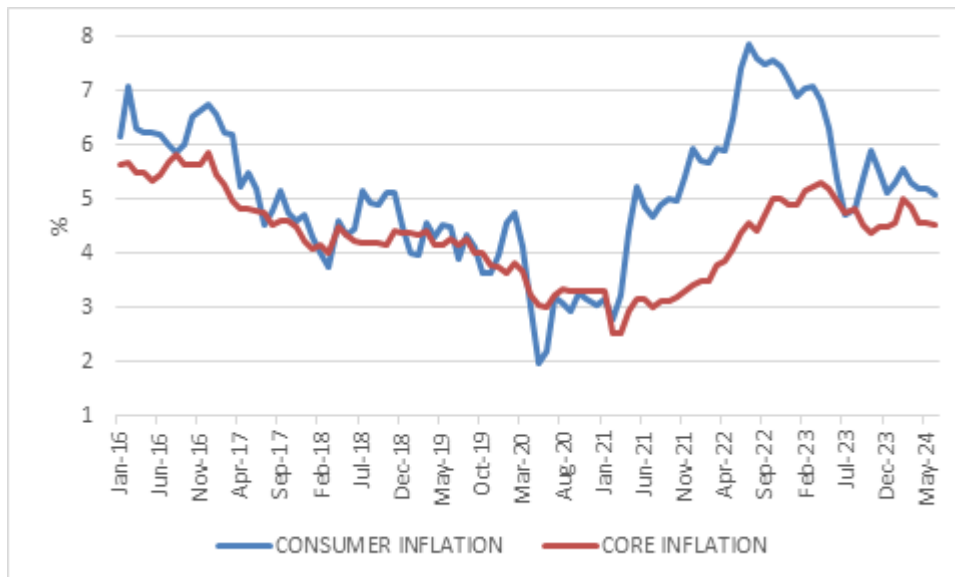
In South Africa, the Reserve Bank's Monetary Policy Committee (MPC) left the repo rate unchanged at its July meeting. This is despite the SARB forecasting that inflation will hit its 4.5% objective next year. If they skate to where the puck is going, they can start cutting already. Two of the six MPC members were in favour of a cut and are skating in that direction.

The concern of the others, presumably including Governor Kganyago, is that inflation expectations are still above the target point. However, expectations tend to follow actual inflation and have already declined meaningfully. The other concern is that a divergence in interest rates between South Africa and other major economies, notably the US, can result in rand weakness as capital tends to flow to where risk-adjusted returns are highest. Rand weakness could upward pressure on inflation.

Backward-looking inflation data, however, continues to improve. Consumer inflation declined to 5.1% year-on-year in June, from 5.2% in May. This doesn't mean prices are falling, just rising more slowly. Core inflation, excluding volatile food and fuel prices, declined to 4.5%, in line with the Reserve Bank's objective. Food and fuel prices obviously matter to consumers, and are very visible, being items that are purchased

regularly. It accounts for a quarter of the consumer price index. However, core inflation is a useful measure of underlying domestic inflationary pressures, since food and fuel prices are largely set in global markets. Notably, rental inflation, which is surveyed quarterly, remains subdued. Owners' equivalent rent and actual rent make up a combined 15% of the CPI basket and had been rising from very low levels. But annual inflation rates of 2.7% and 3.2% respectively still imply soft economic conditions and make the case for lower rates.

Chart 3: South Africa inflation %



Source: LSEG Datastream

This suggests that the SARB will be able to cut rates in September and November, the last two meetings for the year, and a few times next year. This turning point will ease pressure on consumers and indebted businesses, but in South Africa rates are unlikely to decline too much.

Getting GNU-ing

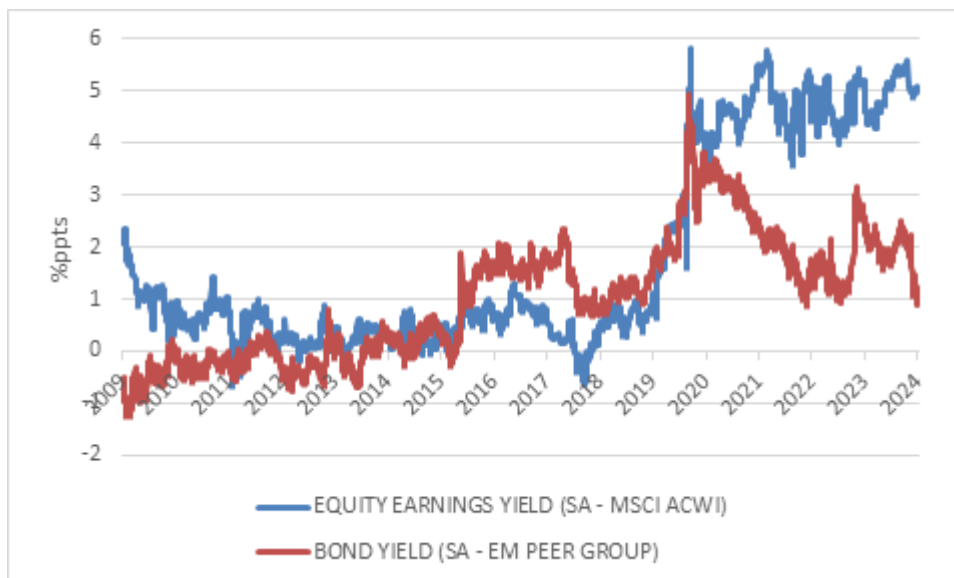
The biggest turning point locally is on the political side, however. Putting the Government of National Unity (GNU) together was a touch-and-go affair, but it seems to be hitting its stride a few weeks in. Importantly, recent presentations by Cabinet ministers and the recent Opening of Parliament Address have mostly hit the high notes. The focus is strongly on accelerating economic growth, crowding in the private sector to develop infrastructure, and building state capacity, including (and crucially) at the municipal level. Though it is impossible to quantify, there seems to be more energy and a greater sense of urgency to deliver than in previous administrations, even though there is likely to be ongoing noise given that ministers are drawn from parties with different ideas and approaches.

The GNU also remains committed to fiscal consolidation, a difficult but necessary endeavour and a case of no pain, no gain if ever there was one. The reality is that borrowing costs are well above nominal economic growth rates and therefore the country is not growing into its debt, as is the case in India for instance. The only option is to reduce borrowing, which is gradually happening, and implementing reforms to boost economic growth, which is also underway as noted above. Fiscal discipline is not fun for

anyone, not least for politicians from various parties who all want to show that they are delivering the goods. Everyone will have to learn to do more with less. Apart from spending less, the other challenge is also to tilt the composition of spending away from consumption towards capex. Details will be forthcoming in the October MTBPS, but the finance minister is expected to continue to stick to a policy of running a primary (non-interest) surplus to reduce borrowing.

If there is success in all the above, a turning point can be reached in the valuations of local asset classes, which have all derated relative to global markets in recent years. As chart 4 shows, the gap between the forward earnings yield (the inverse of the PE ratio) on SA equities and global equities is at multi-year highs. Similarly, the yield on SA's 10-year government bond remains elevated compared to that of an equal-weighted basket of emerging markets peers (Brazil, Mexico, Indonesia, India and Romania). The rand also remains undervalued. When and how this value is unlocked is probably impossible to predict but will almost certainly require patience and evidence that the country has indeed turned the corner. However, there is also no reason to expect a further derating given the more constructive local policy backdrop.

Chart 4: SA vs the World relative bond and equity valuations



Source: LSEG Datastream

Investors in sunny South Africa are largely unfamiliar with ice hockey, a frenetic game with frequent turning points and the odd punch-up. In professional games, players are usually only on the ice for a minute or two at a time before going off to rest. The game is so fast, spectators sometimes struggle to see what is going on, but fans in the Northern Hemisphere, especially Canada, remain passionate and glued to the action. For players it is crucial to keep an eye on the puck, and as Gretzy noted, anticipate where it is heading. Financial markets similarly move at breakneck speed with plenty of twists and turns, and there is often much to distract and stir emotions. Unlike the players on the ice, however, investors can take a long-term view and approach markets with patience. But if there is one lesson investors can learn from the sport, it is to think about where things are headed, not where they are now.