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Market Commentary
Quarter 2, 2022

Global markets tumble on anxieties over inflation

For nearly a half century, global inflation rates were headed one way: down. Since the early 1970s, supported by structural factors that included globalisation, better policy frameworks, big demographic changes, and rapid technological advances, the world achieved a remarkable decline in inflation. But since late 2020, the global inflation rate has risen sharply due to unprecedented macroeconomic policies, pent-up consumer demand, persistent supply disruptions, and surging commodity prices.

Between a rock and hard place

Global markets are now caught between stubbornly high inflation that erodes asset values and central bank tightening that threatens to slow economic growth or even push some nations into recession. Central banks have ramped up their battle against runaway inflation, a necessary remedy that analysts believe could have the adverse side effect of tipping countries into recession. Back in the 1980s, US Fed Chair, Paul Volcker, raised rates as high as 20% and crushed both inflation and the broader economy in the process.

In June, the US Federal Reserve announced its biggest interest rate hike in almost 30 years, followed by the fifth straight rate increase by the Bank of England and the first in 15 years in Switzerland. The European Central Bank (ECB) decided to cease large-scale asset purchases and implemented the euro zone's first interest-rate increase in more than a decade, effectively from July onwards.

Locally, the South African Reserve Bank (SARB) raised its benchmark repo rate by 50bps to 4.75% at its May 2022 meeting and indicated that another 50bps increase is on the cards for July. The May increase is the fourth consecutive hike and the biggest in more than six years due to heightened inflation risks stemming from geopolitical tensions.

> *Inflation has come back faster, spiked more markedly and proved to be more stubborn and persistent than major central banks initially thought possible* – ***World Bank***

Global markets fall sharply

Global stocks and government bonds extended a bruising sell-off this quarter as investors fear that while the rate increases are needed, they could put the brakes on economic growth – company earnings – if the tightening of monetary policy becomes too aggressive. The main factors cited by investors and analysts for the current sell-off in global financial markets and the drag on sentiment are (1) increased monetary tightening by global central banks amid soaring inflation, (2) China's Covid lockdowns and (3) the ongoing war in Ukraine.

- **Monetary tightening**
  The US Fed raised interest by an aggressive 0.75% in June and started unwinding assets – quantitative tightening – accumulated during its fight against the pandemic's effects. The ECB followed suit.
- **Concerns over China's economy**
  Covid Zero has sent ripples through the global supply chain with temporary production halts at the Chinese factories of some of the world's largest companies.

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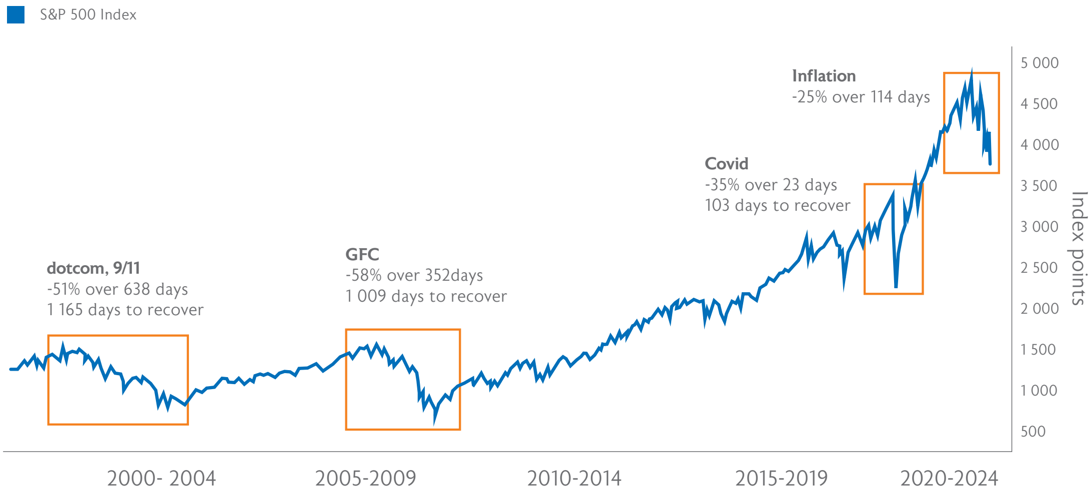
- **Russia's war in Ukraine has fuelled further economic uncertainty**
  By way of an example, the turmoil has caused a supply shock that has driven up oil and other commodity prices.

The S&P 500, the main benchmark for US stock market performance, and roughly half of global stock markets, are down 20.6% year to date, beyond the 20% threshold that some investors consider confirmation of a bear market.

The S&P 500 Index fell 51% from peak to trough between 2000 and 2002, and 58% during the period of the global financial crisis. On both these occasions it took more than 1 000 trading days to recover the losses. In the case of the former, it took 638 days before a low was reached, while for the latter it took 352 days, suggesting the current selloff (-25% over 114 days) might be young in age.

Bear history - Covid sell-off is the only recent bear market with a fast recovery



Source: Bloomberg

The decline of the Nasdaq Composite, which is heavier on technology shares, has been more severe, falling 29.5% so far this year – technically in bear market territory. Typically, higher interest rates are not 'good' for high-growth sectors, where cash flows are often heavily weighted in the future and are diminished when discounted at higher rates. For example, Netflix, is down 70% this year. It is an incredible reversal for a company that saw its share price skyrocket during the pandemic.

Overall, the broader MSCI World Index is down 20.5% year to date in US dollar terms and every sector, besides energy, is in the red.

No place to hide for global bonds

Bonds – which are usually regarded as safe havens when equities sell-off – are also losing money in this equity bear market. Rising inflation and interest rates have negatively impacted the price of bonds, sending the Bloomberg Multiverse Bond Index down 14.0% so far in 2022 – not too far from equity markets. Tighter Fed policy has pushed up bond yields. For example, the yield on the 10-year US Treasury note peaked at 3.47% mid-June, above 2018 levels, when the Fed was reaching the end of its last tightening cycle and far from the 0.6% it reached in April 2020. The May inflation print of 8.6% surprised on the upside, forcing the Fed to raise rates more aggressively.

Emerging markets remain under pressure

Emerging market (EM) equities also stumbled, with the MSCI Emerging Market Index losing 17.6% of its value this year as investors fret over high inflation and a potential hit to the global economy from monetary tightening.

The sell-off in Chinese companies also 'pulled down' the EM Index, with China making up approximately 31% of the index. Growth worries from the nation's Covid Zero policies and lack of concrete measures to support the tech sector triggered further selling. However, sentiment improved towards the end of the quarter and the relaxation of restrictions and fiscal support fuelled a strong rebound in June (+6.7%). The CSI 300 Index in China dropped only 3.1% in Q2 and 8.3% year to date.

Chinese tech – is the tide turning?

The Chinese Communist Party imposed a sweeping crackdown on the tech sector over the past two years under a 'common prosperity' drive, with stringent measures to deal with anti-monopoly practices, information security and social intervention to curb addiction of online games.

The crackdown persisted in the quarter, banning younger users from sending virtual gifts on livestream platforms and ordering central government agencies and state-backed corporations to replace foreign-branded personal computers. This happened after Chinese authorities promised to modify a rule that restricts offshore-listed firms from sharing sensitive financial data with US regulators earlier this year. The changes may pave the way for US authorities to gain full access to auditing reports of Chinese firms listed there, helping resolve a key bilateral dispute that had unnerved investors.

*Hover to see more information

BUT are we really at a turning point? In June we saw 'more action than words' with the government's latest batch of new game approvals. The regulator approved licenses for 60 new games, in what is seen as a step towards policy normalisation. This coupled with a report that the regulator is wrapping up its investigation into Didi Global Inc to make its main apps available for download again, have bolstered sentiment. Didi had a halt placed on 26 of its apps when Beijing decided that the company's data-sharing warranted a closer look. Chinese President Xi Jinping also chaired a top-level meeting in late June approving a plan for the further development of China's large payment firms and the fintech sector.

For these reasons China's technology stocks are currently riding a wave of optimism that a regulatory crackdown on the sector may ease and technical indicators suggest the gains could hold. Overseas funds have turned net buyers YTD (see below). A growing chorus of global investors including JP Morgan Asset Management and Goldman Sachs Group have turned more sanguine on Chinese tech giants, citing attractive valuations and supportive policies.

Flip the script - overseas funds again turn net buyers of China stocks for this year

Source: Bloomberg

Although there is renewed belief that the sky has cleared for Chinese technology companies, there are still plenty of reasons to remain sceptical. Only time will tell if the regime is prepared to sacrifice part of its social agenda.

Locally – the JSE suffered the same fate as global assets

South African equities have also come under pressure, with the FTSE/JSE All Share Index losing 11.7% in the quarter, down 8.3% year to date. Expectations of slow economic growth, higher US bond yields and the problems in China weighed on metal prices. The resources sector reversed most of its Q1 gains, falling 20.7% in Q2. Financial shares also battled, losing 15.3%. In contrast, the industrial sector performed much better, losing only 3.0% for Q2. Prosus, the largest share by market capitalisation on the JSE was up 30.1% in June. This followed its announcement that it plans to sell more of its 28.9% holding in Tencent Holdings to finance a buyback programme – selling Tencent shares at full value and buying back Prosus/ Naspers shares at a considerable discount. Share buy-backs often signal that a company believes its stock is cheap and given the 55% discount to Tencent, it is not surprising that the company went back to its earlier decision of not selling Tencent shares for another three years. Notwithstanding the 'recovery' in the quarter, Prosus is still down 19.4% for this year.

The SA-listed property sector continues to face several issues and lost 12.1% in Q2. Pressure from anchor tenants to reduce rentals and the high office vacancy rates are just some of challenges the sector is facing. But it is not all doom – some office buildings are being repurposed to residential apartments and post Covid recovery, Europe is gaining momentum.

Local bonds – tough environment

Yields on the 10-year bond yield rose from 9.96% to 10.99% and the All Bond Index lost 3.7% in Q2. SA yields were impacted by the negative global fixed income environment but also by the rising domestic inflation concerns. The latest inflation print of 6.5% was on the high side and the SARB responded accordingly. Eskom loadshedding intensified significantly towards the end of June as striking workers impaired the ability to provide a secure electricity supply to the country.

Sanctions – the world is paying for the war in Ukraine

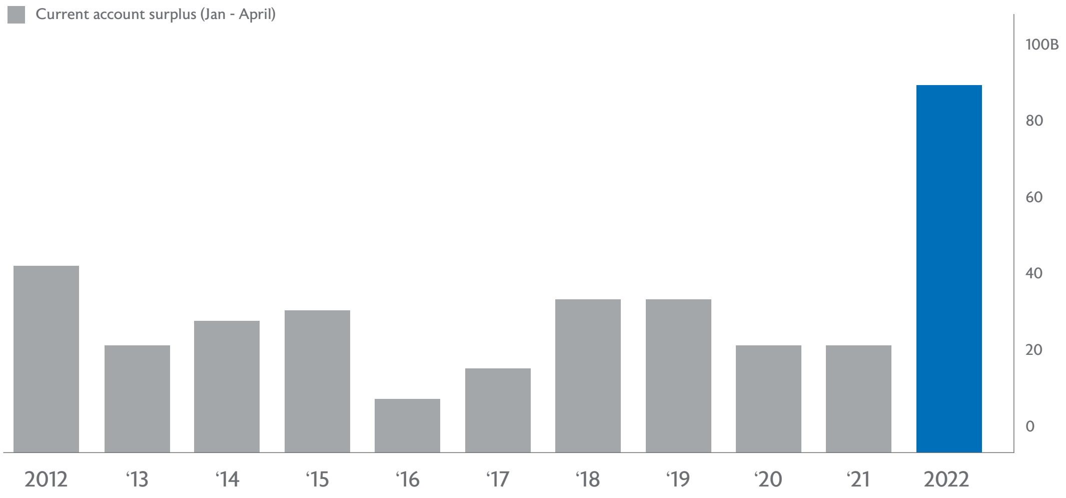
In early March, as the US and its allies unleashed a wave of sanctions on Russia, President Joe Biden said they wanted to deal a "powerful blow to Putin's war machine."

Corporate giants have fled Russia, many walking away from billions of dollars of assets. At the same time the UK, EU, US and other countries have sanctioned hundreds of Russian individuals and entities since February. This includes a partial ban on Russian oil imports and a decision to cut off Russia's biggest bank, Sberbank, from the international payments system, SWIFT. Russia subsequently 'artificially' defaulted on its foreign currency sovereign debt for the first time in a century.

Although the impact of sanctions is expected to be far reaching over time, with billions of dollars in financial reserves and money still coming in from oil and gas exports, Russia has yet to feel the full impact of the barrage of sanctions. The economy is expected to go into a deep recession this year, but its bank account is still overflowing with the revenue from commodities. These have become more lucrative than ever thanks to the surge in global prices driven in part by the war in Ukraine.

Even with some countries halting or phasing out energy purchases, Russia's oil and gas revenue will be approximately $285 billion this year, according to estimates from Bloomberg Economics. That would exceed the 2021 figure by more than one-fifth. Throw in other commodities and it more than makes up for the $300 billion in foreign reserves frozen as part of the sanctions. The current account surplus – the broadest measure of trade in goods and services – more than tripled in the first four months of the year to almost $96 billion, the highest since at least 1994.

Russia's finances are benefitting from a surge in commodity prices



Source: Bank of Russia

Oil export revenue alone is up 50% from a year earlier, according to the International Energy Agency. Russia's top oil producers made their highest combined profit in almost a decade in the first quarter, Moscow-based SberCIB Investment Research estimates. One of the big holes in the sanctions against Russia is the willingness of other nations to continue oil purchases, albeit at a reduced pace in some cases. Indian refiners purchased more than 40 million barrels of Russian oil between the start of the Ukraine invasion in late February and early May. That is 20% more than Russia-India flows for the whole of 2021, according to Bloomberg. China is also strengthening its energy links with the country, including a record quantity of crude oil, lifting purchases to $7.47 billion – double the 2021 amount.

When it comes to gas, Russia has fewer options for diverting supplies, but the countries at the end of pipelines from Russia are also locked into a mutual dependency. About 40% of the EU's gas needs are met by Russia. European deliveries even jumped in Q1 as the invasion caused a price spike in European gas hubs, making purchases from Russia's Gazprom PJSC cheaper for most customers with long-term contracts. Even as the EU reduces its dependency there are complications at every step. Several large buyers of Russian gas have gone out of their way to keep buying the crucial fuel, and utilities such as Italy's Eni SpA and Germany's Uniper SE expect supplies to continue – the Putin 'machine' is still very much operational.

Inflation-recession tightrope

John Maynard Keynes, an early 20th-century British economist best known as the founder of modern macroeconomics, believed that some inflation was necessary to prevent the Paradox of Thrift. This paradox states that if consumer prices are allowed to fall consistently because the country is becoming too productive, consumers learn to hold off their purchases to wait for a better deal. The net effect of this paradox is to reduce aggregate demand, leading to less production, layoffs, and a faltering economy.

However, higher-than-normal inflation, such as the current environment, is bad for any economy.

The tools now being used by leading central banks will certainly help to contain inflation. Unfortunately, central banks must undertake these measures at a time of increasing stagflationary risks. Global growth is decelerating rapidly and inflationary pressures are intensifying because central banks do not have control over some of the problems that are lifting inflation – such as the commodity-price shock exacerbated by the Ukraine crisis and supply shortages.

Targeting the correct rate of interest – at which monetary policy is neither contractionary nor expansionary – is difficult at the best of times. It is even trickier in a high-inflation environment when trade-offs must be made. A wrong move now could easily spoil the incipient post-pandemic recovery.

Hence, striking the right balance between economic expansion and price stability is more art than science, but globally central banks strive to achieve it in order to sustain positive global growth.

Conclusion

There is no doubt that fears of a global recession are mounting. Investors' faith in a soft landing for the world's largest economy is being heavily tested, as more frequent and aggressive interest rate hikes from central banks stir worries over recession and more volatile trading ahead.

> *"Steep interest-rate hikes could tip the US economy into recession and a soft landing may be very challenging"*
>
> - ***Fed Chair Jerome Powell***

Financial conditions are likely to tighten further. Consumers are experiencing a significant negative sentiment shock, energy and food supply disruptions have worsened and the outlook for foreign growth has deteriorated. The World Bank slashed its annual global growth forecast to 2.9% from January's 4.1%. Consumer confidence in the world's largest economy dropped sharply and domestically plunged to its lowest level in 30 years according to the FNB Consumer Confidence Index.

> *"Fear can lead to the actuality of recession if it makes consumers, investors, and companies more cautious"*
>
> - ***Yale economist Robert Shiller***

Conversely, there are still market economists who are more positive that global markets could 'sidestep' a recession. Let us all hope central banks can pull it off and land the global economy without a crash/recession. Also, may sanity prevail with a peace deal of some kind that puts an end to the war, and further easing of Chinese lockdowns to help abate the supply-chain pressures in order to lessen anxieties over inflation and global growth.

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