

INVESTMENT NOTE

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IN SEARCH OF GOLDILOCKS



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Over the past 15 years, the idea of a 'Goldilocks' global economy – not too hot, not too cold – has been on investors' radar screens. In this environment, there is enough economic growth to keep company earnings ticking over, but there is no overheating that results in elevated inflation, forcing central banks to hike rates.

Clearly, Goldilocks has been absent of late, with the pandemic causing wild swings in economic activity, company profits, inflation and eventually, a surge in interest rates. Along the way there have been simultaneous bear markets in global bonds and equities, a rare occurrence. Could we be re-entering Goldilocks territory? Or are the bears about to return from their walk in the woods?

THE RULE OF THREE

In storytelling, a 'rule of three' often applies. It is the idea that we understand concepts, situations, and characters better when they are grouped in three. Hence *The Three Little Pigs*, *The Three Billy Goats Gruff*, *The Three Musketeers*, *The Lion, the Witch and Wardrobe* and so on. In Goldilocks, there are three bears, obviously, but also three scenes of action: the kitchen, the living room, and the bedroom.

Let's consider at a high level our own rule of three for macro analysis: the outlook for growth, inflation and interest rates.



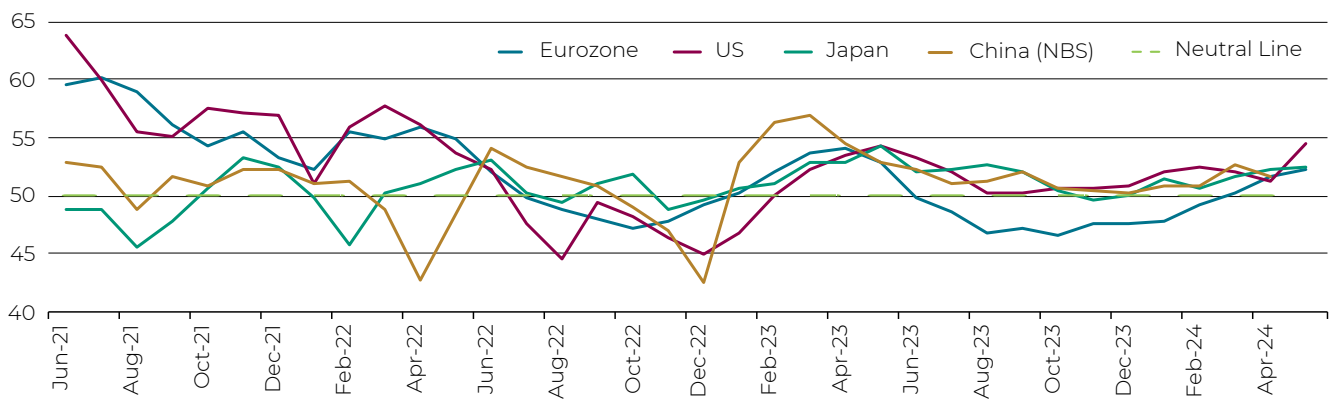
GLOBAL GROWTH

By far the biggest risk to investors with an equity-heavy portfolio is a global recession, more specifically a recession in the US, the most important economy for markets. Therefore, gauging the likelihood of a severe slowdown is priority number one. There is good news on this front.

One of the timeliest indicators of global growth is the purchasing managers' indices (PMI) produced by S&P Global. These are also constructed to be easy to read, with a level of above 50 indicating expansion.

S&P Global released the latest composite (manufacturing and services) PMI for the US last week, and it rose sharply from 51.3 in April to 54.4 in May, the highest level since April 2022. This suggests business activity remains healthy and risk of an imminent recession is low. The Eurozone PMI similarly rose to 52.3 in May, up from 51.7 in April. Japan's PMI points to the fastest expansion in business activity in nine months. China's latest PMIs will only be released in the coming week, but these too have risen in recent months, pointing to improved business conditions.

CHART 1: S&P GLOBAL COMPOSITE PURCHASING MANAGER'S INDICES



Source: LSEG Datastream

While one should consider a broad range of indicators to make a judgement over the health of the economy, the snapshot picture provided by these PMIs point to ongoing global economic resilience. Particularly important is that other major economies seem to be closing the gap with the US.

When the US is the strongest among major economies, it tends to result in a strong dollar which depresses growth

elsewhere. When the growth momentum is more balanced between major regions, the dollar tends to ease and this in turn reduces pressure throughout the global financial system. Remember the dollar remains the international currency of choice for denominating debt contracts. The Bank for International Settlements estimates that dollar-denominated lending to non-banks outside the US amounts to around \$12 trillion. When the dollar is strong, it effectively increases the burden of servicing this massive pile of debt.

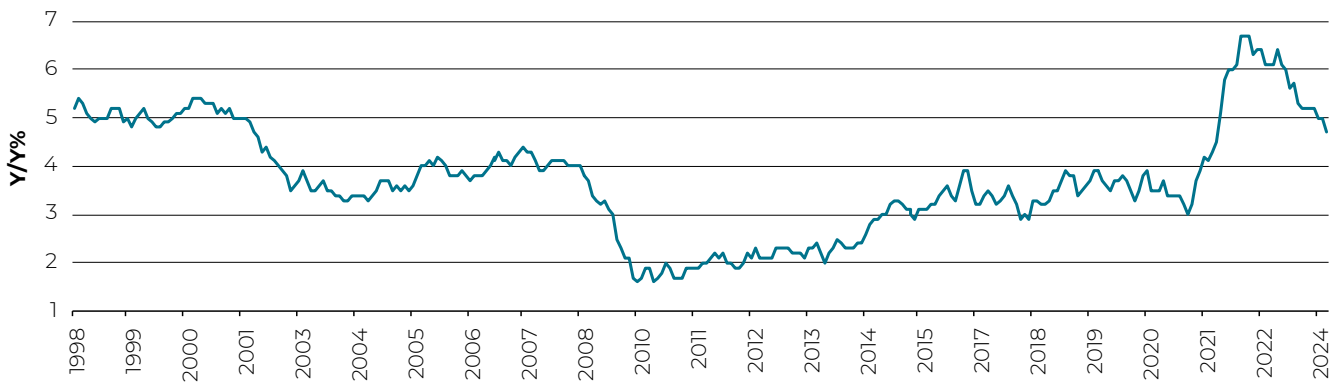
INFLATION

Inflation continues to decline in major economies, but unevenly so, with signs of stickiness in places. In particular, US service inflation remains elevated. This is partly because of strong demand for services, and partly because service prices are more exposed to wage pressures (wages are proportionally a bigger input cost for a restaurant than a factory, for instance). A third reason is simply that rental and insurance inflation as measured by the official numbers

reflect the lagged effect of pandemic disruptions. Therefore, they should decline in the months ahead though it is taking longer than expected.

The pandemic also distorted labour markets, leading in the case of the US to the fastest wage growth in decades. This too is easing off as the market normalises. Further cooling will be necessary for the Fed to gain confidence that the inflation will indeed improve further.

CHART 2: US WAGE GROWTH TRACKER



Source: Atlanta Federal Reserve Bank

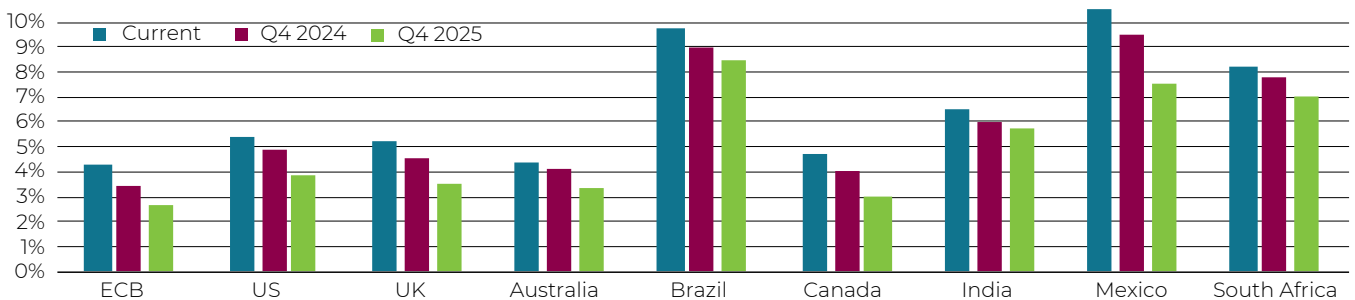
INTEREST RATES

The move up in interest rates was highly synchronised, but with the move down there are leaders and laggards. Many emerging markets have already started cutting, including Brazil, Hungary and China (it should be noted that interest rates are not always the main monetary policy tool in China, so modest rate cuts do not imply that the People’s Bank has been sitting on its hands). Among developed economies, Sweden and Switzerland have cut rates, with the market now pricing in a European Central Bank cut early next month and the Bank of England in August. The US Federal Reserve, the most important of the lot, is priced to cut in September. The Bank of Japan is going the opposite direction, with a hike priced in for July, though it may be the last of the cycle.

It is easy to get hung up on the timing of these rate cuts, but that is much less important than the general direction. There are three things to note. Firstly, though inflation might still be sticky and elevated, in most countries it is no longer at a crisis level and therefore rates don’t need to be at crisis levels.

Central banks can be more balanced in their assessment of the inflation and growth outlook and set interest rates with future inflation in mind. This means there is some scope for rates relief. Secondly, only in extreme cases, like Turkey, is a deep cutting cycle on the cards. Chart 3 summarises the consensus interest rate forecast for selected large economies. By the end of next year, rates are expected to be lower than today, but not dramatically so. Compared to the pre-pandemic decade, this still counts as a higher-for-longer rates environment, with implications for economic activity and market pricing. Thirdly, the one good thing about elevated interest rates is that they can fall. There is room for large rate cuts should the global economy hit the wall. In other words, while it is impossible to know what lies ahead over the next year or so, should things go wrong, policymakers have ammunition. The fear of the past two or so years was that there would be a US recession, with high inflation preventing the Fed from responding. That would have been the exact opposite of ‘Goldilocks’, but now seems unlikely.

CHART 3: CONSENSUS INTEREST RATE FORECASTS



Source: Reuters

SOUTH AFRICA

In the original version of Goldilocks, it is an old woman, not a little blonde girl, who walks into the home of three male bachelor bears. When discovered, she jumps out the window and is never seen again. Similarly, it feels as if South Africa has not seen Goldilocks in a very long time. Growth has been too weak, and inflation too high.

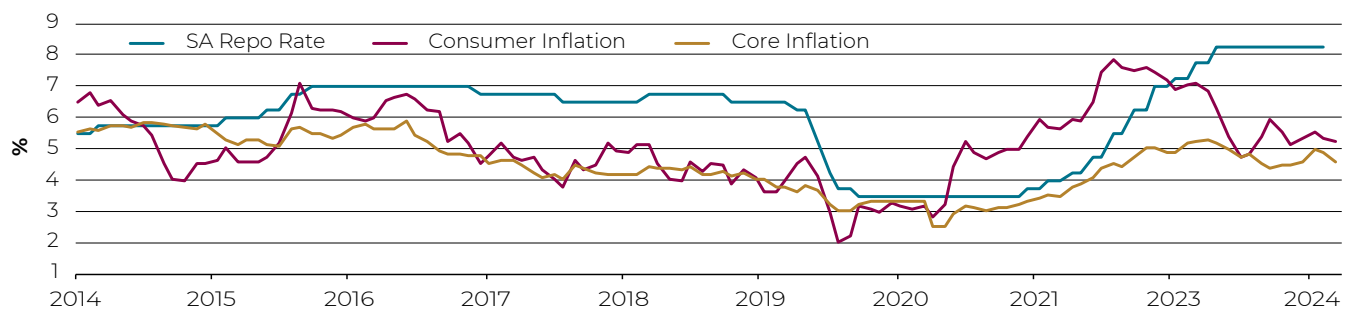
Supply-side problems, notably loadshedding, has been a common problem on both the growth and inflation front. Without turning one swallow into a summer, the two-month streak of uninterrupted power is very encouraging. It shows some stabilisation on the part of Eskom, but more importantly a continued increase in private energy generation. Operation Vulindlela, the joint initiative of National Treasury and the Presidency aimed at unblocking growth constraints, noted in its latest update that almost 6 000MW in private renewable projects has already been registered with Nersa, while there is still a large pipeline of projects at various stages of development that will connect to the grid in the years ahead. Whatever happens with the election, these reforms are unlikely to be rolled back since no party wants loadshedding. Therefore, electricity supply interruptions should continue

to decline over time, which boosts the growth outlook and reduces some inflationary pressures. But much else needs to improve in terms of infrastructure provision and the quality of public services and regulation to get the country to sustainable growth rates above 3%. We'll also need lower interest rates, both short-term policy rates set by the Reserve Bank, but also lower bond market rates. The latter will remain elevated until there is more progress in stabilising government debt levels. As for the Reserve Bank, the local inflation outlook is key, but the global interest rate picture also matters.

Domestic consumer inflation eased to 5.2% year-on-year in April, from 5.3% in March and 5.6% in February. While still above the Reserve Bank's 3% to 6% target range, this was slightly lower than the market expected. Core inflation, excluding volatile food and fuel prices, moderated to 4.6% from 4.9%.

Provided the election results do not deliver a negative shock that sends the rand tumbling, this paves the way for the Reserve Bank to start reducing the repo rate soon, though unlikely at this week's meeting.

CHART 4: SA INFLATION AND INTEREST RATES



Source: LSEG Datastream

In summary, we're not quite in 'Goldilocks' territory yet internationally, but we are moving that way. Global economic growth is positive, but the risk of overheating is much lower. Inflation has generally declined without too much trouble but remains stubbornly high in certain sectors. This implies a shallower rate-cutting cycle but does not mean there will be no cuts. It remains a relatively good backdrop for equity markets, though off course corrections can and will happen from time to time.

Locally, the growth outlook is improving as we make progress in tackling the electricity and logistics shortcomings, but it will take time (the first quarter's growth numbers could well be negative when they are released next month). Local rates should also move lower as the inflation picture improves.

The election can still surprise in any direction, but once it is over, there will be one less thing to obsess about. South African assets remain cheap. Unlocking this value will depend on improvement in domestic fundamentals and a supportive global environment.

One of the reasons the rule of three is so prevalent in stories is that it can present three paths, the one being the wrong way, the other an opposite but equally wrong direction, while the third, middle path, is just right. Christopher Booker, author of *The Seven Basic Plots*, writes that the "idea that the way forward lies in finding an exact middle path between opposites is of extraordinary importance in storytelling". In asset allocation, there is of course a similar search for balance that takes the appropriate path between risk and opportunity.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 462.0	-0.32%	4.75%	9.25%	24.13%
United States	S&P 500	US\$	5 305.0	0.04%	5.34%	11.22%	28.92%
Europe	MSCI Europe	US\$	2 154.0	-0.74%	4.46%	6.63%	14.27%
Britain	FTSE 100	US\$	10 595.0	-0.94%	4.14%	7.61%	12.34%
Germany	DAX	US\$	1 752.0	-0.34%	6.05%	12.24%	16.41%
Japan	Nikkei 225	US\$	246.3	-1.16%	1.20%	3.78%	11.94%
Emerging Markets	MSCI Emerging Markets	US\$	1 083.0	-1.55%	3.54%	5.76%	11.53%
Brazil	MSCI Brazil	US\$	1 525.0	-3.72%	-2.68%	-15.28%	2.49%
China	MSCI China	US\$	60.8	-4.86%	5.35%	9.66%	0.18%
India	MSCI India	US\$	1 030.9	2.35%	3.20%	11.81%	35.65%
South Africa	MSCI South Africa	US\$	416.0	-2.12%	6.39%	0.24%	10.93%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	79 151.0	-0.48%	4.04%	2.94%	4.67%
All Share	All Share (Total Return)	Rand	14 208.0	-0.46%	4.18%	4.84%	8.87%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	34 746.1	-0.46%	4.14%	4.72%	11.55%
TOP 40/Large Caps	Top 40	Rand	12 930.0	-0.64%	4.16%	5.04%	7.36%
Mid Caps	Mid Cap	Rand	22 504.0	-0.26%	5.52%	3.30%	16.20%
Small Companies	Small Cap	Rand	33 953.0	0.51%	2.98%	3.96%	16.79%
Resources	Resource 20	Rand	5 372.7	-1.54%	2.35%	10.51%	-2.61%
Industrials	Industrial 25	Rand	23 766.0	-0.67%	4.62%	7.04%	8.39%
Financials	Financial 15	Rand	12 829.0	0.39%	4.15%	-0.64%	23.57%
Listed Property	SA Listed Property	Rand	1 951.5	1.43%	1.43%	4.70%	21.67%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	74.2	-0.66%	1.01%	-5.38%	-3.65%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	948.2	-0.61%	1.22%	0.83%	12.67%
Government Bonds	BESA GOVI	Rand	934.1	-0.61%	1.25%	0.77%	12.62%
Inflation Linked Bonds	BESA CILI	Rand	348.7	-0.07%	-0.11%	-0.15%	7.74%
Cash	STEFI Composite	Rand	566.5	0.16%	0.54%	3.36%	8.51%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	82.1	-2.21%	-4.51%	6.65%	5.28%
Gold	Gold Spot	US\$	2 333.0	-3.36%	0.65%	13.09%	18.19%
Platinum	Platinum Spot	US\$	1 035.0	-4.61%	9.99%	4.86%	0.98%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.43	-1.46%	1.96%	-0.70%	4.46%
ZAR/Pound	ZAR/GBP	Rand	23.47	-1.75%	0.00%	-0.72%	1.41%
ZAR/Euro	ZAR/EUR	Rand	19.98	-1.17%	0.33%	1.08%	3.53%
Dollar/Euro	USD/EUR	US\$	1.08	0.93%	-1.20%	2.22%	0.00%
Dollar/Pound	USD/GBP	US\$	1.27	-0.29%	-1.87%	-0.30%	-2.65%
Dollar/Yen	USD/JPY	US\$	0.01	0.80%	-0.56%	11.28%	12.52%

Source: I-Net, figures as at 24 May 2024

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