

INVESTMENT NOTE

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INFLATION STILL POSES QUESTIONS



IZAK ODENDAAL

OLD MUTUAL MULTI-MANAGERS

This week is the unhappy first anniversary of Russia's unexpected unprovoked invasion of Ukraine. Global energy markets were shocked, sending oil, gas and coal prices spiking higher. Food prices also jumped, as Ukraine's famed black soils makes it one of the world's breadbaskets.

This gave the global inflation surge already underway renewed impetus. Prices were already rapidly rising over a broad front largely due to pandemic-related supply disruptions and the sudden and unexpected shift in consumer spending from face-to-face services to use-at-home goods. Consumer spending in developed countries also benefited from government stimulus.

While the war sadly continues, energy prices have stabilised at pre-invasion levels. Putin's attempt to use gas as an economic weapon against the West has failed, but the West's attempts to curtail Russian oil exports have not been entirely successful either. Russia has found new customers in India and China, just as Europe found new sources of gas supplies. Agricultural prices are similarly back to earth, though it will take time for this to filter through to retail food prices.

The disruptions caused by the pandemic are also fading. Logistical logjams have eased, transport prices have normalised, and production is running smoothly. In fact, acute shortages have in many instances given way to surpluses. Microchips are the poster child for this tomato sauce bottle effect when at first nothing comes out, and then, after shaking the bottle, everything comes out at once. Hence the global manufacturing sector is experiencing a downturn as inventories rise and production is scaled back, putting downward pressure on manufactured goods prices.

The declines in goods and commodity prices means that headline inflation rates are falling from four decade-highs in developed countries and multi-year highs in developing countries such as South Africa. So far, so good.



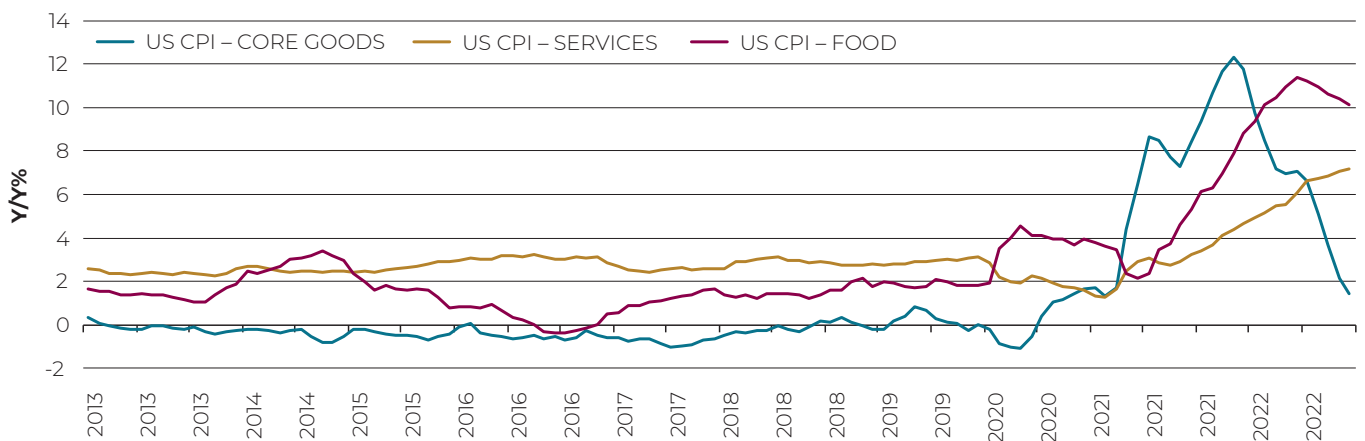
WEALTH

MAKING WAVES

However, this does not mean the inflation dragon has been slayed. Service inflation in the developed world remains high and is rising in many cases. This reflects the fact that consumer spending is shifting back to services – people only need so many exercise bikes, additional computer screens and coffee machines – but also that labour is scarce across these countries. Services are more labour-intensive. You can put robots in a factory but not in a restaurant, hair salon or pharmacy, not yet anyway.

Chart 1 illustrates these three waves using the US as an example. First the increase in “core” goods inflation (goods excluding food and energy), then the further jump in food and energy inflation following the invasion. But now that goods and commodities are declining, service inflation remains high.

CHART 1: US INFLATION TRENDS



Source: Refinitiv Datastream

Staying with the US, since the American central bank, the Fed, effectively sets interest rates for the whole world, we know that service inflation will eventually decline as a big portion of it is related to housing, or shelter as it is termed. The way shelter inflation is calculated lags the housing

market by several months and the latter has slowed down considerably due to the jump in interest rates. Private companies that track rental growth, for instance, indicate that this has turned negative in the past few months, while the official data still points to big monthly gains.

WORKER PUZZLES

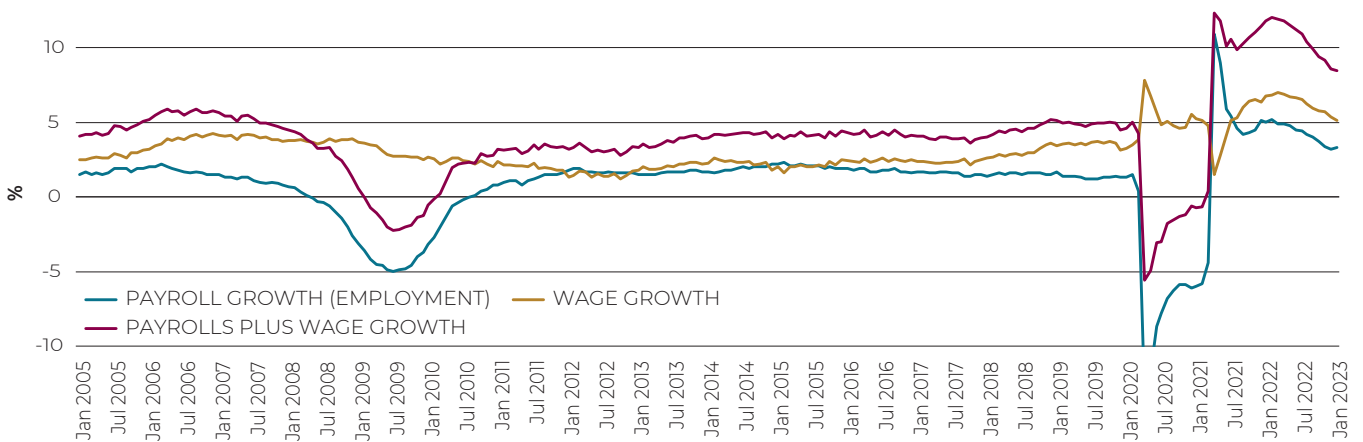
But other types of services might still see sustained upward price pressures due to the very tight labour market. US unemployment at a 50-year low of 3.5%. In the UK, despite its economic malaise, it is 3.7%. In the Eurozone, unemployment is lower than it has ever been since the formation of the single currency.

Worker shortages can cause push and pull inflation. If it causes wages to rise rapidly, firms will try to raise selling prices to maintain margins. But rising wages also means workers potentially have the income to spend more, raising demand. As prices rise, workers will demand even higher wages. This wage-price spiral is the stuff of nightmares for

central bankers since the only way out is usually a severe recession.

The good news on this score is that, while wage growth is the highest it has been in years, it does not seem to be accelerating. This is a bit of a puzzle. It could mean that workers don't feel like they have much bargaining power. It could also mean that workers generally expect inflation to subside and therefore do not see the need to push for even larger increases. Indeed, surveys suggest that households don't expect inflation to be a long-term problem. This is in stark contrast to the 1970s, when a wage-price spiral was in full flight with expectations of future inflation anchored at higher levels and union power at its zenith.

CHART 2: US WAGE AND EMPLOYMENT GROWTH



Source: Refinitiv Datastream

The same strong labour demand that can cause inflation is also supporting consumer spending. A simple calculation is to look at the growth in wages (roughly 5%) plus the growth in employment (around 3%). This adds up to 8% in the US according to the latest data, implying total worker income growth is comfortably ahead of inflation which was at 6.4% in January. This means the odds of a US recession have greatly diminished, even though there is weakness in key sectors such as housing and manufacturing. Consumer spending is 70% of the US economy, and if household incomes keep growing in real terms, spending can grow in real terms.

It is only when the labour market comes under pressure that the picture changes. Companies could decide they need to downscale their workforce as margins come under pressure from wage costs. But for the time being, strong top-line sales growth means that it is unlikely. Despite some high-profile job cut announcement from Silicon Valley, somewhat reversing a pandemic hiring spree, there is no sign of an increase in retrenchments. Unemployment claims, a weekly datapoint, remain historically low.

In other words, overall inflation is subsiding, but with different components moving at different speeds in different places. A stronger-than-expected economy in the US and Europe means the path down to low and stable inflation is unlikely to be a quick or smooth process. Even Chinese inflation picked up a bit last month as the economy reopens after months of lockdowns.

This implies that the global rate hiking cycle is not over yet.

However, it is fair to say that most rate increases are behind us. The strategy of the Fed and most other central banks was to quickly move rates up to restrictive territory, and most are there or almost there. In the case of the Fed, rates jumped from near 0% to 4.5% in the space of only 12 months. The next few months could see it hike another 0.5% to 1%, depending on how the data evolves, before pausing.

The bar for rate cuts is still very high. There will need to be clear evidence not only of headline inflation falling, but also of the various underlying components moving in the right direction, even if they move at different speeds. That includes evidence of a better balance between demand and supply in the jobs market.

There are still so many unknowns, and remember, a central bank cannot control inflation directly. By changing interest rates, it hopes to impact spending and investment decisions with a lag, which in turn impact price-setting, also with a lag. All this in a time of tremendous uncertainty. It is like driving in the fog with a delay between when you turn the steering wheel or step on a pedal and when the car responds.

Investors also have a tough time deciphering the often-mixed economic signals. In addition, they (we) have to guess how policymakers will respond, even though those policymakers are also unsure.

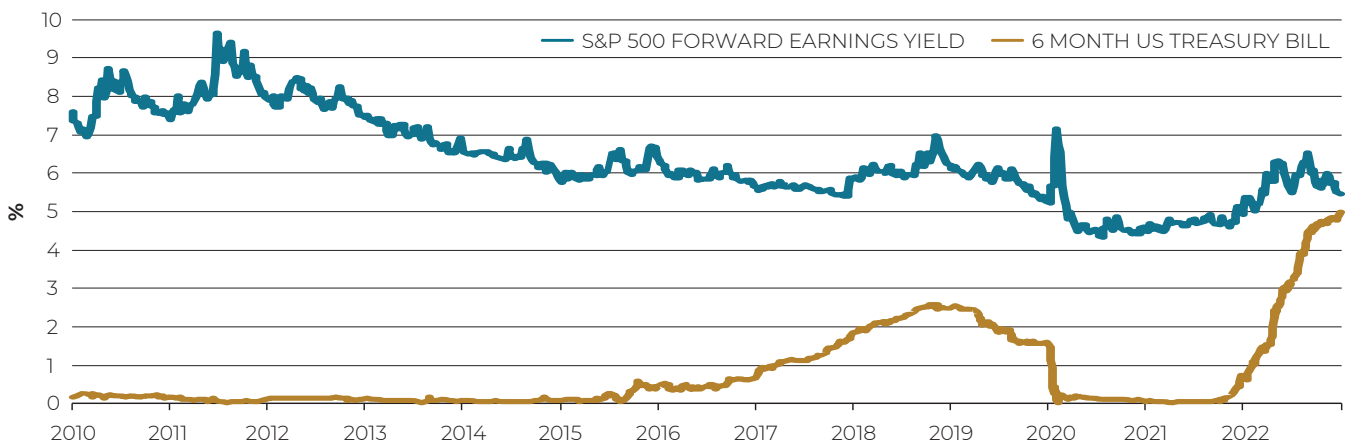
HIGHER-FOR-LONGER

What we do know is that we are looking at better global economic growth than feared a few months ago, but also a higher-for-longer interest rate scenario.

Theoretically, this should imply decent earnings growth but also a lower rating (price to earnings multiple). So far this year, however, multiples have expanded (i.e. earnings yields have fallen) as earnings growth has not yet accelerated in line with the better economic outlook.

Clearly, it is a messy picture with good news and bad news and everything in between. There is reason to be optimistic about equities, but not reason enough to go overweight in a global portfolio. And with cash and bond yields at multi-year highs, the cost of being somewhat defensive has declined substantially.

CHART 3: US YIELDS



Source: Refinitiv Datastream

LOWER LOCAL INFLATION

South African inflation has also been greatly influenced by the global surge in fuel and food prices, but local dynamics are very different. Businesses, particularly retailers, face unusual cost pressures at the moment due to constantly running diesel generators. The rand weakness of the past year also puts upward pressure on prices. However, domestic demand has been weak, and this limits the ability for companies to pass on price increases. If your customers can't afford to pay higher prices, there is little point doing it.

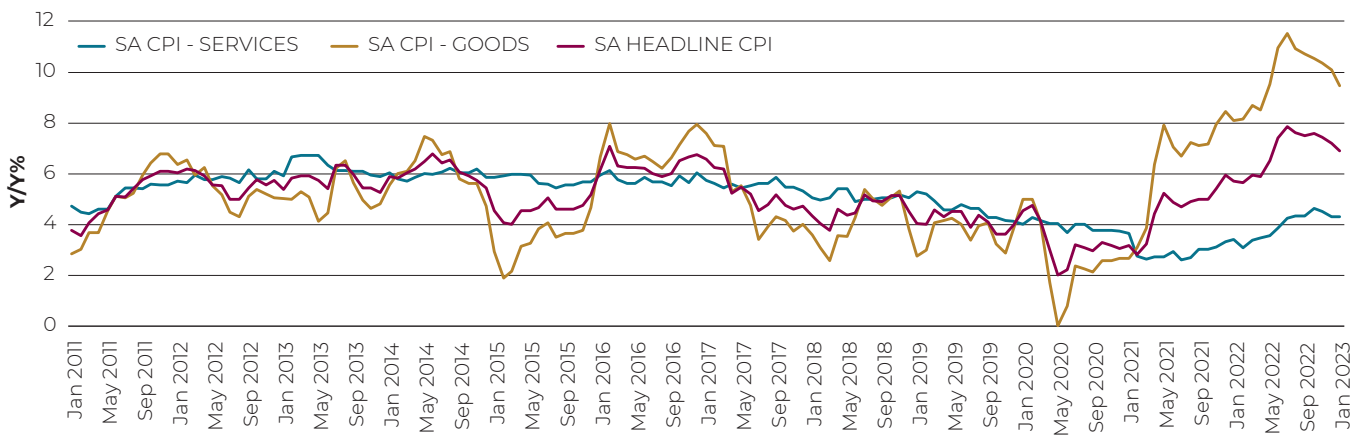
Headline inflation declined to 6.6% in January, compared to a recent peak of 7.7% in November. Goods inflation, including food and fuel, has dipped below double digits and pulled headline inflation lower. Food inflation remains stubbornly high, but there are signs of lower agricultural inflation in the producer price index that should eventually

filter through. Another petrol price hike is likely next week, but fuel prices are still below the mid-2022 peak.

There are signs of rand weakness impacting some items in the goods basket, such as vehicles. The rand has been the weakest of the highly traded currencies this year, with loadshedding largely to blame. It has underperformed other commodity producing currencies by some margin. Goods inflation is largely influenced by global prices and the exchange rate while service inflation is much more local in nature.

Service inflation has increased since the lows of the pandemic lockdowns, but at 4.2% remains lower than the pre-pandemic average. The gap between services and goods remains near record-wide reflecting weak domestic demand.

CHART 4: SOUTH AFRICA HEADLINE, GOODS AND SERVICE INFLATION



Source: Stats SA

On the other hand, South Africa does have a more ingrained inflationary psychology. In the formal sector, annual inflation adjustments to wages and salaries are common and disconnected from productivity growth. This persists despite high unemployment, in contrast to the experience in developed economies. This is a constant worry for the

Reserve Bank, though it too is close to the peak of the hiking cycle, if not there already. While the door remains open to another 0.25% basis points hike in March if the rand continues to slide, domestic inflation data continues to broadly move in the right direction.

WHICHEVER WAY THE WIND BLOWS

The bottom line is that some things can change quicker than you think, while other things are much more persistent than you imagine. A year ago, Russia did the unthinkable and upended global energy markets, altering the global geopolitical landscape, probably permanently. Late last year, China made an unexpected U-turn on its Covid policy, setting the country up for an economic rebound. The most

recent data from the US and Europe shows healthier economies than previously, but this can lead to lingering inflation. While headline inflation rates are falling from extreme levels, they might be stubborn on the way down. Therefore, if you are going to rely on forecasts, make sure you update them often. Even better, ensure you are appropriately diversified, whichever way the wind blows.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 780.0	-0.14%	-0.18%	6.80%	-7.61%
United States	S&P 500	US\$	4 079.0	-0.27%	0.05%	6.22%	-6.87%
Europe	MSCI Europe	US\$	1 892.0	1.28%	0.58%	9.24%	-5.82%
Britain	FTSE 100	US\$	9 636.0	1.37%	0.66%	6.89%	-6.09%
Germany	DAX	US\$	1 485.0	1.23%	0.47%	11.22%	-8.33%
Japan	Nikkei 225	US\$	205.1	-2.57%	-2.35%	3.06%	-13.45%
Emerging Markets	MSCI Emerging Markets	US\$	999.0	-1.48%	-3.10%	4.50%	-19.63%
Brazil	MSCI Brazil	US\$	1 474.0	2.22%	-5.27%	1.03%	-12.57%
China	MSCI China	US\$	67.7	-2.18%	-5.32%	5.83%	-19.59%
India	MSCI India	US\$	738.1	-0.37%	-1.19%	-4.27%	-10.32%
South Africa	MSCI South Africa	US\$	419.0	-1.41%	-4.99%	-0.48%	-19.27%

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	79 272.0	0.36%	-0.26%	8.52%	4.09%
All Share	All Share (Total Return)	Rand	13 472.0	0.37%	-0.26%	8.61%	8.83%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	32 617.7	-0.07%	-0.87%	6.03%	5.12%
TOP 40/Large Caps	Top 40	Rand	12 357.0	0.29%	-0.27%	9.39%	10.11%
Mid Caps	Mid Cap	Rand	20 610.0	0.86%	-0.04%	3.78%	1.54%
Small Companies	Small Cap	Rand	30 686.0	0.89%	2.08%	4.45%	10.60%
Resources	Resource 20	Rand	5 764.0	-2.07%	-6.31%	0.34%	-3.05%
Industrials	Industrial 25	Rand	22 060.0	1.47%	2.77%	16.52%	16.97%
Financials	Financial 15	Rand	11 087.0	0.89%	0.59%	4.60%	5.51%
Listed Property	SA Listed Property	Rand	1 682.6	0.29%	0.45%	-0.55%	1.36%

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\$	77.2	-1.19%	-2.67%	0.21%	-16.02%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	871.5	-0.89%	-1.30%	1.63%	2.34%
Government Bonds	BESA GOVI	Rand	859.1	-0.91%	-1.34%	1.61%	2.24%
Inflation Linked Bonds	BESA CILI	Rand	322.7	-0.08%	-0.10%	-1.07%	2.26%
Cash	STEFI Composite	Rand	512.1	0.14%	0.33%	0.93%	5.61%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	83.0	-3.92%	-2.35%	-3.49%	-10.75%
Gold	Gold Spot	US\$	1 843.0	-1.23%	-3.36%	1.04%	-2.28%
Platinum	Platinum Spot	US\$	917.0	-2.96%	-9.30%	-14.54%	-14.86%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.05	-0.90%	-3.55%	-5.66%	-16.96%
ZAR/Pound	ZAR/GBP	Rand	21.73	-0.69%	-1.29%	-5.25%	-6.07%
ZAR/Euro	ZAR/EUR	Rand	19.30	-1.20%	-2.03%	-5.60%	-11.77%
Dollar/Euro	USD/EUR	US\$	1.07	0.00%	1.50%	0.00%	6.54%
Dollar/Pound	USD/GBP	US\$	1.20	0.18%	2.18%	0.52%	12.98%
Dollar/Yen	USD/JPY	US\$	0.01	2.05%	3.10%	2.31%	16.73%

Source: I-Net, figures as at 17 February 2023

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WEALTH

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