

# INVESTMENT NOTE

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## STORMS AND ANCHORS



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**It is a stormy world out there, literally and figuratively. As Hurricane Milton smashed into the Florida coast, it was a reminder of the awesome power of nature. Sustained windspeeds of around 160km/h tore the roofs off buildings, a storm surge pushed coastal sea levels up more than two meters, and an unimaginable amount of rain bucketed down. The storm also spawned more than a hundred tornados. Moreover, it is the second hurricane to hit the region in quick succession, following Hurricane Helene in late September.**

The practice of giving tropical storms names dates back to the early 1900s but became commonplace after World War II. The idea is to allow for effective communication to the general public around these very dangerous events. Interestingly, however, the practice of alternating between male and female names could be counterproductive. A 2014 study published in the Proceedings of the National Academy of Sciences showed that the death toll from hurricanes with female names was higher than with male names. The authors suggested that people could be underestimating the intensity of a storm when it has a feminine-sounding name and end up taking fewer precautions as a result.

If true, this would be just another example of how easily we are misled by our brains, sometimes with deadly results. There are, of course, entire academic fields related to this topic, including behavioural finance, which studies the myriad ways in which our cognitive processes let us down when making investment decisions through inbuilt bias and the use of mental shortcuts.



## ANCHORS AWAY

One of these is the habit of anchoring. When thinking about market prices, the reference point looms extremely large. For instance, when the rand-dollar exchange rate is R17.50, is that strong or weak? If your reference point is the level of R17.10 it reached late September in the wake of the US Federal Reserve's big rate cut, you might say the rand looks a bit shaky. However, if your reference point is the level of R19.40 a year ago, it will look strong. The appropriate reference point is something analysts spend a lot of time thinking about, since it clearly plays a role in the outcome of the assessment – something we'll get back to later. For most people, however, the reference point is usually simply a number they can remember clearly. Or it is the first number they are presented with.

In a classic 1974 study, Daniel Kahneman and Amos Tversky, pioneers in the field, asked people to spin a wheel that the participants believed would generate a random number, though it actually landed on either 10 or 65. They were then asked to guess the percentage of African members of the United Nations. Those for whom the wheel landed on 10 guessed 25% on average, and those for whom the wheel landed on 65, guessed 45%. The completely unrelated and supposedly random number generated by wheel therefore anchored their estimate of the percentage of African countries higher or lower.

## INFLATED

A current example is the way that economists and ordinary folks talk past one another when it comes to inflation. To an economist, "inflation" means the change in the broad price level over a fixed period, usually over 12 months. For the proverbial man in the street, inflation refers to the cost of living. If stuff costs more than they did at some point in the past, inflation is high – even if the price hasn't changed much over 12 months.

Take the US gasoline (petrol) price, which will likely play an outsized role in the upcoming election, since it is a very visible reflection of the cost of living in a country where the

car is king. Gasoline was on average cheaper in Donald Trump's turn in office (early 2017 to early 2021) than during Joe Biden's presidency, \$2.4 on average versus \$3.4. Neither president has much control over fuel prices, but people will remember that it was cheaper in Trump's time. Moreover, they will remember that the price hit the unimaginable level of \$5 a gallon soon after Biden took office. Again, it has little to do with him per se, since fuel prices spiked globally in the wake of Russia's invasion of Ukraine.

**CHART 1: US REGULAR GASOLINE AVERAGE PRICE**



Source: Energy Information Administration

Today, however, the gasoline price has declined quite nicely to around \$3. To an economist, this is 17% lower than a year ago, and therefore detracting from headline inflation. And if you are anchoring off \$5, it will seem a lot cheaper. But if your reference point was the pre-Covid times when it hovered around \$2.5, you are still going to feel aggrieved.

Both the Trump and the Harris campaigns therefore have a strong incentive to influence which reference points people anchor off. The same is true for the prices of other mainstay items in people's consumption baskets.

New data showed that US consumer inflation declined to 2.4% year-on-year. In other words, the consumer price index – a broad measure of the prices of goods and (mainly) services – was 2.4% higher than in September 2023. The inflation rate is down considerably from the 9.1% peak in June 2022. However, the index is 20% higher than pre-Covid levels, and 14% higher than where a simple projection of the pre-Covid trend would suggest we should be.

Again, to an economist and monetary policymakers this is good news. But lower inflation doesn't mean lower prices apart from fuel prices, which are very volatile, and hence excluded from the "core" inflation measure. In fact, core inflation has been sticky around 3% year-on-year since it has a large weight to owners' equivalent rent, the implied number that homeowners theoretically pay themselves, but don't pay in real life.

Despite the fact that the US economy seems to be in good shape from an outsider's perspective, with low unemployment, steady income growth, falling inflation and rising wealth levels, many Americans don't feel positive at all. The jump in the cost of living is a shock they are still recovering from. Ongoing political polarisation can't help either. Unfortunately for the rest of us, we are forced to be spectators in this very close election race, even though sometimes the actions of American presidents impact the rest of the world as much as America itself. It feels unfair that we have no say.

But that is the outsized power that the US wields, and it is even greater when it comes to financial markets. In particular, the decisions of the Federal Reserve reverberate across the financial world. Its next policy meeting will be held on 7 November, after the votes are cast but not necessarily counted.

The outlook for the Fed's is constantly repriced in markets, particularly fixed income and currency markets. The last week or so has seen rate cut expectations pared back somewhat.

Again, the anchoring plays a role. If we say that rates will fall "less than expected," we are referring to an expectation formed at a specific point in time. Compared to a different reference point, rates might end up being much lower. A year ago, for instance, the fear was that the Fed would have to increase rates, and markets sold off heavily. That is one of the reasons why 12-month return numbers will look very generous for the next few weeks. Compared to the pre-Covid era of near-zero interest rates, it seems likely to end up at much higher levels.

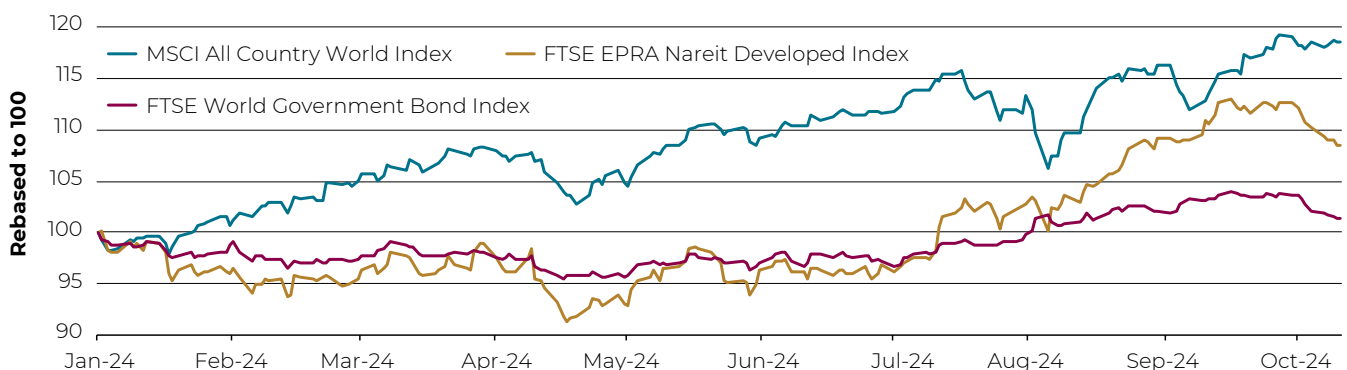
Still, the bottom line is that the Fed is cutting rates, and should continue to do so, even if there is uncertainty where they will ultimately settle. Inflation is still moving in the right direction, even if there are some sectors where price pressures are sticky, and some months where the data is disappointing. A return to sustained inflation below 2%, which was the case before Covid in the US and Europe, seems unlikely but inflation hovering between 2% and 2.5% should be acceptable to the Fed, even if it would not admit it. Global growth is still resilient, though unexciting. There are sectors under pressure in the US economy, notably manufacturing and housing but overall, consumer spending is growing at a healthy pace. There are also countries with unique problems – Germany's overreliance on car manufacturing and China's on real estate – but the overall picture seems good. This is supportive macro backdrop for markets, particularly for equities.

## A GOOD YEAR

That is why, despite the various geopolitical storm clouds and the uncertainty of the US elections, global equities are performing well this year. The enthusiasm for interest rate

sensitive assets – bonds and real estate – has waned somewhat but returns are still in positive territory for the year, despite a very wobbly start to 2024.

**CHART 2: GLOBAL ASSET CLASSES IN 2024 IN DOLLARS**

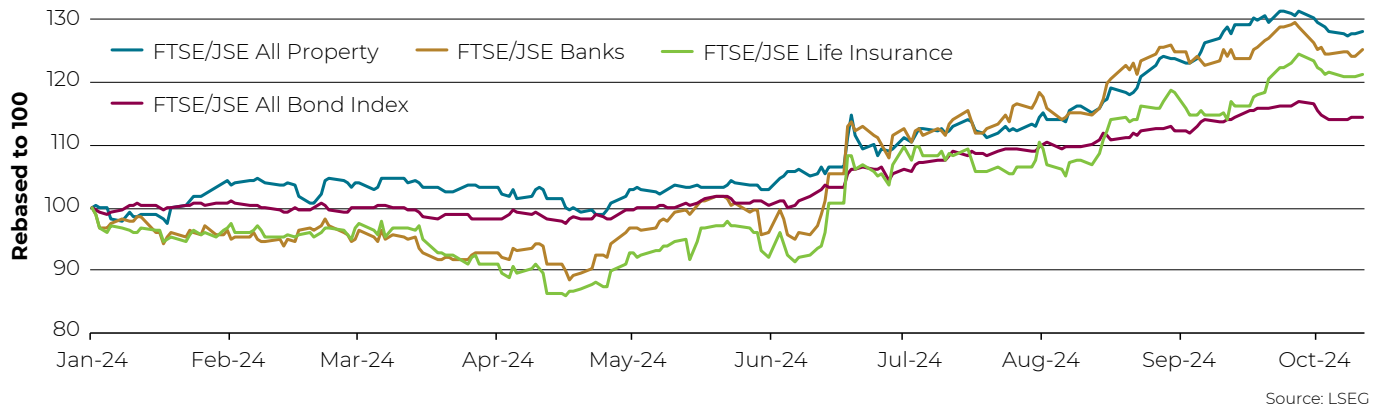


Source: LSEG Datastream

In South Africa, the rally in local interest rate-sensitive investments also seems to have lost some steam, but markets never move in a straight line, so this is neither surprising nor concerning. It does seem, however, that further improvement will rely on positive news on the growth outlook, which would boost government bonds.

The feelgood factor of the GNU has definitely helped on the streets and in the markets since the election, but the Budget is where the rubber hits the road, so the upcoming Medium-Term Budget Policy Statement will be an important milestone.

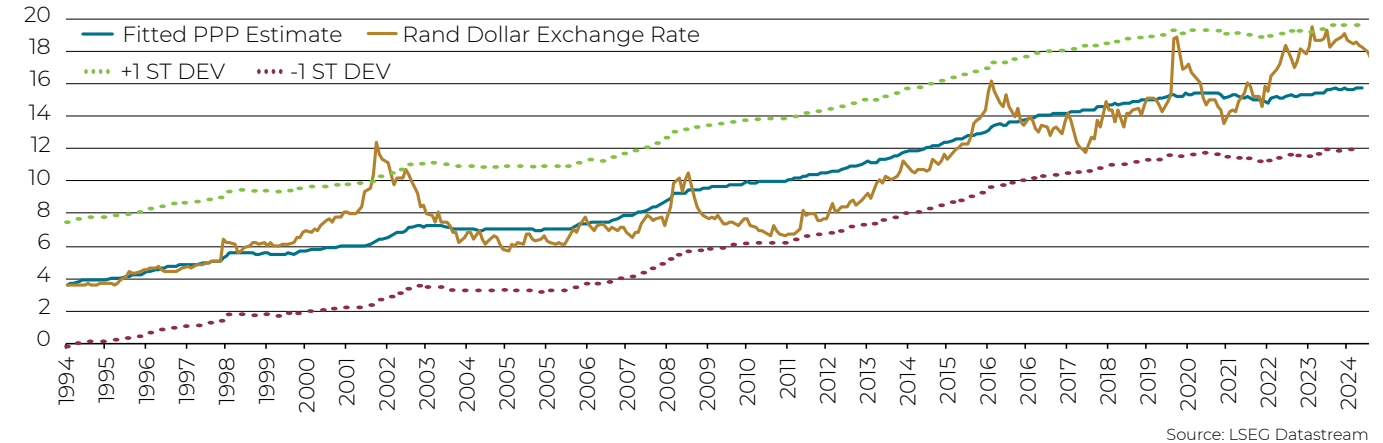
**CHART 3: SA INTEREST RATE-SENSITIVE INVESTMENTS**



Finally, returning to the question of the rand's fair value, it is as much art as science. As noted, it is quite a bit stronger than the May 2023 low of almost 20 to the dollar, but still much weaker than the "14-handle" of early 2022. And how many people remember that it was as strong as R11.57 against the dollar in February 2018, hardly a lifetime ago? One valuation approach is to employ the theory of purchasing

power parity (PPP), which holds that the exchange rate will reflect inflation differences between two countries over time. Since higher inflation will erode one country's competitiveness relative to the other, its currency will fall to adjust for this. A PPP estimate suggests a fair value range around R15.70.

**CHART 4: RAND-DOLLAR EXCHANGE AND SA-US INFLATION DIFFERENTIAL**



Another way to think about it is simply that the rand was battered by several storms in recent years. Most notably, the US dollar has been globally strong, up 25% on a trade weighted basis over 10 years. Commodity prices, particularly platinum and palladium, have been soggy. Emerging markets have also generally fallen out of favour with global investors, and South Africa has done little to convince them

otherwise, through loadshedding, logistics crises, and policy and political uncertainty. Some of these headwinds are now easing and some turning into tailwinds. The good thing about storms, after all, is that they ultimately pass. The trick is to have an investment strategy that is diversified and valuation-based to avoid anchoring incorrectly and getting buffeted by the wild market winds.

## EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 732.0	0.92%	0.24%	17.77%	28.69%
United States	S&P 500	US\$	5 815.0	1.11%	0.92%	21.91%	32.85%
Europe	MSCI Europe	US\$	2 180.0	0.46%	-2.07%	7.92%	18.22%
Britain	FTSE 100	US\$	10 758.0	-1.01%	-2.36%	9.26%	14.65%
Germany	DAX	US\$	1 834.0	0.60%	-1.66%	12.58%	27.36%
Japan	Nikkei 225	US\$	265.1	2.02%	0.39%	11.71%	23.81%
Emerging Markets	MSCI Emerging Markets	US\$	1 160.0	-1.61%	-0.94%	13.28%	21.21%
Brazil	MSCI Brazil	US\$	1 428.0	-3.71%	-4.10%	-20.67%	-7.75%
China	MSCI China	US\$	69.8	-7.01%	-0.24%	25.83%	19.87%
India	MSCI India	US\$	1 112.2	0.18%	-3.12%	20.63%	34.81%
South Africa	MSCI South Africa	US\$	485.0	0.00%	-1.22%	16.87%	26.63%

## 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	86 149.0	-0.21%	-0.46%	12.04%	16.65%
All Share	All Share (Total Return)	Rand	15 677.0	-0.01%	-0.20%	15.68%	20.96%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	38 377.7	0.01%	-0.20%	15.66%	22.31%
TOP 40/Large Caps	Top 40	Rand	14 051.0	-0.14%	-0.39%	14.14%	18.55%
Mid Caps	Mid Cap	Rand	25 456.0	0.02%	-0.33%	16.85%	27.48%
Small Companies	Small Cap	Rand	41 642.0	1.12%	0.68%	27.50%	38.06%
Resources	Resource 20	Rand	5 009.2	-1.94%	-0.11%	3.04%	0.16%
Industrials	Industrial 25	Rand	25 874.0	-0.83%	-1.12%	16.53%	21.24%
Financials	Financial 15	Rand	16 084.0	2.09%	0.55%	24.58%	36.46%
Listed Property	SA Listed Property	Rand	2 420.7	1.73%	-0.14%	29.87%	51.20%

## 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\$	76.9	-0.80%	-2.66%	-1.93%	5.07%

## FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 080.1	0.51%	-1.62%	14.85%	22.67%
Government Bonds	BESA GOVI	Rand	1 063.1	0.51%	-1.61%	14.69%	22.52%
Inflation Linked Bonds	BESA CILI	Rand	370.4	-0.45%	-0.83%	6.07%	11.88%
Cash	STEFI Composite	Rand	584.4	0.15%	0.24%	6.63%	8.54%

## COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	79.0	1.27%	9.78%	2.65%	-8.09%
Gold	Gold Spot	US\$	2 646.0	-0.26%	-0.23%	28.26%	41.72%
Platinum	Platinum Spot	US\$	978.0	-1.01%	-1.31%	-0.91%	10.26%

## CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.56	-0.39%	-1.66%	4.23%	7.25%
ZAR/Pound	ZAR/GBP	Rand	22.89	0.31%	0.92%	1.79%	1.27%
ZAR/Euro	ZAR/EUR	Rand	19.17	0.10%	0.31%	5.37%	4.27%
Dollar/Euro	USD/EUR	US\$	1.09	0.92%	2.20%	1.28%	-2.75%
Dollar/Pound	USD/GBP	US\$	1.31	0.50%	2.60%	-2.76%	-5.82%
Dollar/Yen	USD/JPY	US\$	0.01	-0.09%	3.45%	5.35%	-0.40%

Source: I-Net, figures as at 11 October 2024

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