

# INVESTMENT NOTE

15 JULY 2024

## A TALE OF TWO INFLATIONS



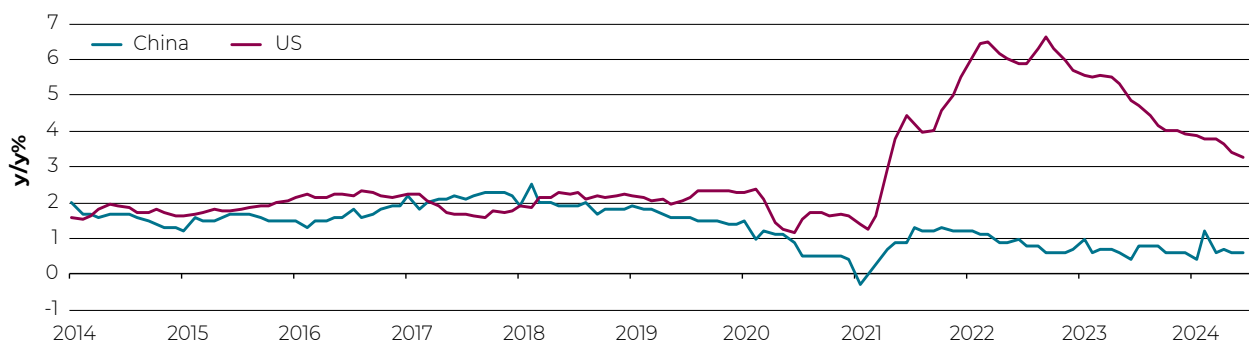
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**People love complaining about inflation, however, few find it a particularly interesting topic. Like your blood pressure can give the doctor a pretty good sense of your overall well-being, inflation can tell us a lot about the underlying strength of an economy. The past week saw the release of inflation data from both the US and China, the world's largest two economies. In both cases, the data was slightly lower than expected, but it still tells the story of very different economic dynamics.**

Starting with China, core inflation has been running below 1% for most of the past three years. Core inflation excludes food and fuel prices that are volatile and can distract from the business of understanding underlying inflationary and economic processes.

**CHART 1: CHINA AND US CORE INFLATION**



Source: LSEG Datastream



WEALTH

Weak inflation points to some combination of weak demand or excess supply. Japan went through a long period of persistently low (often negative) inflation over the past 25 years. Other developed countries experienced stubbornly low inflation after the global financial crisis. The pandemic and subsequent inflation surge have seemingly jolted North America, Europe and even Japan out of this low inflationary torpor.

China, on the other hand, did not experience a post-pandemic inflationary episode, and instead seems to be belatedly experiencing its turn of low inflation. The common denominator across these very different economies and their episodes of low inflation was private sector debt and a real estate bubble. Japan's property bubble burst in 1990. In the West, the end of the subprime bubble almost sunk the North Atlantic banking system in 2008.

China's giant property sector has been experiencing a painful correction since the government introduced the "three red lines policy" in 2020 to rein in leverage, particularly among developers. While it has been successful on its own terms, officials at the time did not necessarily realise the extent of the collateral damage they would cause.

Not only is sales and construction activity way down, but predictably, house prices have fallen (though they probably have not been allowed to fall as much as would be the case in a free market). The property implosion has severely dented confidence among Chinese consumers, since homeownership rates are high by global standards at around 90%. It is also the main vehicle for long-term savings, instead of retirement funds or equity portfolios. As many households feel a lot poorer, they are reluctant to spend.

For local governments, land sales to developers was a big source of income that has now largely dried up. As a result, they are cutting back on services and employment.

A weak property sector is not the only reason behind low inflation. Beijing's policy response also matters. Interest rates were tweaked lower, and there have been some support packages aimed specifically at the property sector. The main thrust of intervention has rather been aimed at stimulating advanced manufacturing – "new quality productive force" as the policy is termed – such as electric

vehicles, batteries and semiconductors. But with domestic demand still tepid, increased industrial output only serves to put further downward pressure on prices. Of course, one avenue for this excess production has been exports. Export growth has been solid, but other economies are increasingly pushing back, even if cheap Chinese imports helps keep inflation down. The US imposed steep tariffs on Chinese electric vehicles a few weeks ago, and the European Union has made similar noises.

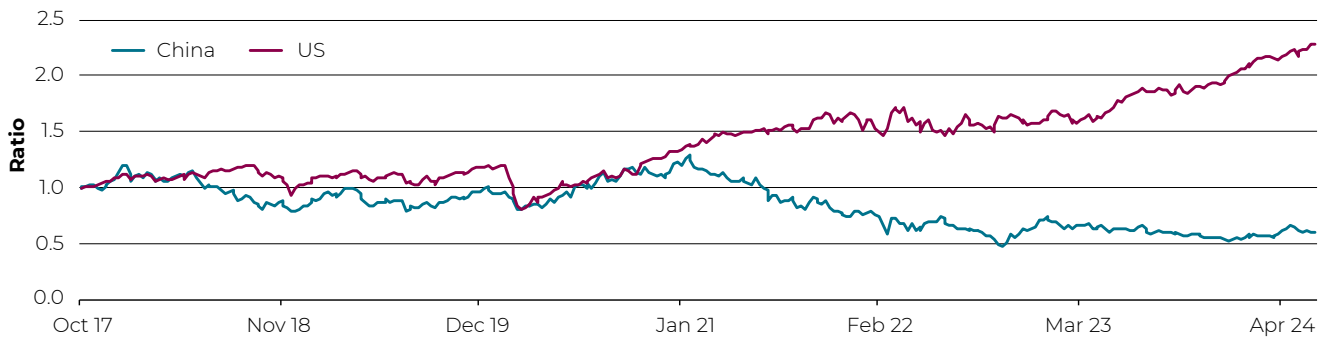
The lesson from burst property bubbles in other countries is that the process of working through the overhang of excess inventory and excess debt takes time, usually years. Eventually, however, time heals all wounds, and that includes wounded balance sheets.

Policy can speed this process up, but so far support for the property has been targeted and limited. This week will see Communist Party brass convene for the Third Plenum, a key policy-making forum for the next few years. While many commentators are calling for a large stimulus plan to kickstart domestic demand, this seems unlikely. The focus will probably remain on sectors deemed strategic from a national security point of view, and ongoing management of debt levels. Therefore, there is still no consumption boom on the horizon.

Reflecting the expectations for lower future inflation and interest rates, Chinese government bond yields have fallen substantially over the past three years, meaning bond prices have risen. The yield on the 10-year Chinese government bond yield has fallen from 3.3% at the start of 2021 to the near record-low levels of 2.2% today. More recently, the rally in Chinese bonds has been driven by speculative buying, partly because property and property-linked investments are out of favour. In fact, the People's Bank of China has intervened in the bond market to calm things down.

Chart 2 shows how Chinese bonds have outperformed equities, while the opposite has been true in the US. US equities have been flying (apart from big drawdowns in 2020 and 2022) while bonds have endured a torrid time since it became clear in 2021 that the Fed would have to embark on a major hiking cycle. From the start of 2021, the 10-year US bond yield rose from 0.9% to 4.3%.

**CHART 2: RATIO OF EQUITY TO BOND TOTAL RETURNS, LOCAL CURRENCY**



Source: LSEG Datastream

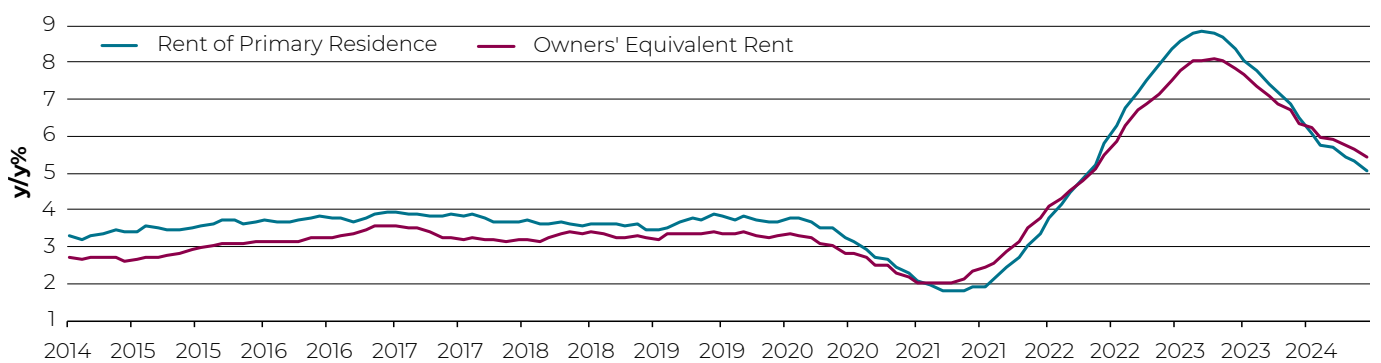
This brings us to the US housing market and US inflation. The surge in interest rates meant that the breaks were slammed on construction and sales activity in the US residential real estate market too. But unlike in China, there was no bubble and in fact, the US is undersupplied with houses. By now it is well known that most US homeowners with mortgages have locked in very low mortgage rates (below 3%) and are therefore reluctant to sell and take out a new mortgage at a rate around 7%. The market is frozen, in other words, but can thaw quickly if borrowing costs decline.

The housing market plays an important role in the US inflation story too, but for very different reasons. Housing-related costs make up 40% of the core consumer inflation basket. Since a house itself is a capital good (an investment),

what goes into the CPI is the service that is extracted from the house. Some people rent homes or apartment, and rentals are included into the index, but for homeowners an implied rent called owners' equivalent rent is imputed. In other words, government statisticians calculate what homeowners would pay if they rented the property from themselves.

The rental numbers that go into the US CPI also lag the latest market-based rental adjustments because they sample in-force rental agreements, not only new ones. Therefore, the official rental inflation data has been elevated for a considerable period, even as market-based rentals have declined. This has been a big contributor to overall inflation, but the downtrend in rental inflation is underway as chart 3 shows.

**CHART 3: US SHELTER INFLATION**



Source: LSEG Datastream

The overall US consumer price index rose by 3% from a year ago in June, a slower increase than economists expected.

Core inflation of 3.3% year-on-year is at the lowest level since April 2021.

## TWO-SIDED RISKS

While this is clearly not 2% yet, inflation continues to move slowly in the right direction (also bear in mind that the Fed's preferred inflation gauge, the PCE deflator, usually runs about half a percent lower than CPI inflation).

As Fed Chair Jerome Powell noted in testimony to Congress last week, the risks facing the Fed are now two-sided. When inflation was still at multi-decade highs in 2022 and 2023, the focus was purely on bringing it under control. The Fed was prepared to cause a recession to do so – and indeed many expected that only a recession could bring inflation down. The biggest risk facing the central bank was that inflation would not fall or would reaccelerate after a brief decline.

Today, however, inflation is at more comfortable levels even though it is clearly still above the Fed's 2% target. The risk that inflation can reaccelerate from these levels is not zero, but it is small. The greater risk at this point is probably that interest rates remain too high for too long, putting the squeeze on vulnerable sectors in the economy.

## YUAN MORE TIME

If the Fed finally embarks on a cutting path, it will not only relieve pressure on fragile sectors of the US economy, but also elsewhere in the world, including China. One of the reasons why the Chinese policy response to economic weakness has been measured is probably the fear of further yuan weakness.

This has been a pattern across the world, including South Africa to an extent. Central banks set interest rates with only one eye on domestic inflation and economic dynamics,

Crucially, upside risks to inflation from the labour market seem very limited. Wage growth has slowed to 4% year-on-year, and job openings have declined meaningfully. Increasingly, market commentators are noting the increase in the unemployment rate to 4.1%, though it remains low by historic standards.

The challenge for central banks is that they need to set interest rates today that will impact the economy in the future, based on data from the past. Too much focus on the past data, and they might misread the future completely. Nonetheless, the combination of a cooling labour market, lower historic inflation and increased vulnerability of certain pockets of the US economy such as housing construction, small businesses and low-income households, builds the case for the Fed to start cutting rates soon, probably at its September Federal Open Markets Committee meeting.

since the other eye is often focused on the Fed. This is because capital tends to flow to where risk-adjusted returns are the highest, and investors can earn a risk-free 5.5% in short-dated US government bonds. No wonder the dollar has been so strong, and the yuan (and other currencies) so weak. For all the talk of the yuan rivalling the dollar as a global reserve currency, the foreign exchange market has been telling a different story.

**CHART 4: YUAN-DOLLAR EXCHANGE RATE**



Source: LSEG Datastream

South Africa is geographically far away from both the US and China. However, what happens in these two giants probably has a greater impact on local investors than decisions made in the Union Buildings in Tshwane or the Parliament in Cape Town. The US has an outsized impact on financial markets, while China is the largest single export destination. To the extent that the two giants pull in different directions in the years ahead, countries like South Africa

will face tough choices. Or to put it differently, with skilful diplomacy, South Africa can reap benefits from its relationship with both superpowers.

The more immediate story is optimistic. The prospect of lower US interest rates is positive for local financial markets and supports the case for the South African Reserve Bank to start lowering its policy rate, if not this week, then at its next meeting.

## EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 628.0	1.31%	3.30%	14.48%	21.46%
United States	S&P 500	US\$	5 615.0	0.86%	2.84%	17.71%	25.56%
Europe	MSCI Europe	US\$	2 183.0	2.20%	4.20%	8.07%	12.01%
Britain	FTSE 100	US\$	10 719.0	1.96%	3.83%	8.87%	11.29%
Germany	DAX	US\$	1 774.0	2.19%	4.60%	13.20%	12.56%
Japan	Nikkei 225	US\$	260.9	2.49%	6.00%	9.93%	13.12%
Emerging Markets	MSCI Emerging Markets	US\$	1 124.0	1.72%	3.50%	9.77%	11.73%
Brazil	MSCI Brazil	US\$	1 484.0	2.63%	5.40%	-17.56%	-9.18%
China	MSCI China	US\$	59.4	2.79%	3.52%	7.10%	-2.33%
India	MSCI India	US\$	1 096.7	0.49%	2.21%	18.95%	34.73%
South Africa	MSCI South Africa	US\$	444.0	2.54%	3.98%	6.99%	8.03%

## 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	81 686.0	1.10%	2.48%	6.23%	6.72%
All Share	All Share (Total Return)	Rand	14 694.0	1.11%	2.53%	8.43%	11.02%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	35 960.8	1.00%	2.51%	8.38%	12.02%
TOP 40/Large Caps	Top 40	Rand	13 296.0	1.32%	2.39%	8.01%	8.90%
Mid Caps	Mid Cap	Rand	23 533.0	0.35%	2.23%	8.02%	18.46%
Small Companies	Small Cap	Rand	37 132.0	-0.45%	3.76%	13.69%	24.82%
Resources	Resource 20	Rand	5 313.1	-0.10%	4.78%	9.29%	1.21%
Industrials	Industrial 25	Rand	23 897.0	1.98%	1.79%	7.63%	6.38%
Financials	Financial 15	Rand	14 313.0	1.49%	1.91%	10.86%	25.37%
Listed Property	SA Listed Property	Rand	2 099.4	0.49%	2.81%	12.63%	30.97%

## 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\$	75.1	1.15%	1.74%	-4.27%	-3.09%

## FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 025.6	1.53%	3.32%	9.06%	17.38%
Government Bonds	BESA GOVI	Rand	1 010.2	1.53%	3.31%	8.98%	17.29%
Inflation Linked Bonds	BESA CILI	Rand	358.8	0.34%	0.70%	2.74%	9.34%
Cash	STEFI Composite	Rand	572.7	0.16%	0.31%	4.50%	8.55%

## COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	85.0	-1.74%	0.04%	10.43%	6.29%
Gold	Gold Spot	US\$	2 412.0	0.88%	3.70%	16.92%	24.72%
Platinum	Platinum Spot	US\$	1 000.0	-2.91%	0.60%	1.32%	5.26%

## CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.95	1.25%	1.31%	1.92%	1.03%
ZAR/Pound	ZAR/GBP	Rand	23.32	-0.13%	-1.33%	-0.09%	1.03%
ZAR/Euro	ZAR/EUR	Rand	19.58	0.61%	-0.41%	3.17%	3.12%
Dollar/Euro	USD/EUR	US\$	1.09	-0.92%	-1.74%	1.28%	1.83%
Dollar/Pound	USD/GBP	US\$	1.30	-1.33%	-2.99%	-2.22%	0.09%
Dollar/Yen	USD/JPY	US\$	0.01	-1.77%	-1.83%	11.97%	13.99%

Source: I-Net, figures as at 12 July 2024

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