

INVESTMENT NOTE

23 JANUARY 2023

TWO-FACED MARKETS IN A TWO-FACED MONTH



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OLD MUTUAL MULTI-MANAGERS

January is named for Janus, the Roman god of archways and doorways. Janus is also the god of beginnings, hence the first month of the year carrying his name. He is famously depicted as having two faces, one looking forward and one looking back.

In the spirit of Janus, the first note of 2023 looks back on last year and forward to see how the main macro themes are evolving, starting with inflation.

DOWN BUT NOT OUT

The good news is that inflation rates across the world have peaked and are heading lower. In the US, for instance, consumer inflation hit an annual rate of 9% in June but had fallen to 6.4% in December. In the Eurozone, the decline is less pronounced but still there, with consumer inflation falling to 9.1% in December from a peak of 10.6% in October.

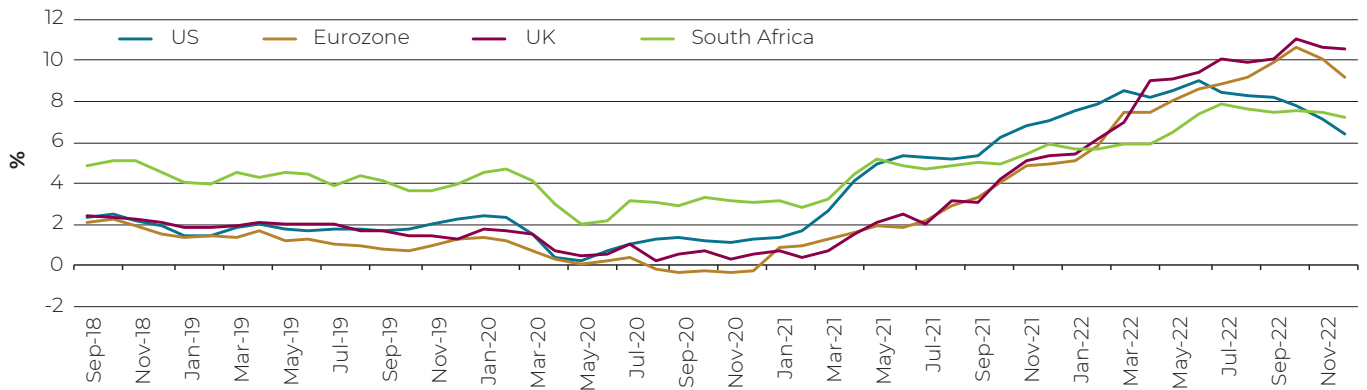
However, the big question remains whether inflation has been knocked out for good. Most of the declines in the headline numbers are due to falling goods inflation (in some instances, falling goods prices). But service inflation continues to rise steadily. In the US, this is partly due to rental inflation which should peak and decline soon given the weakness in the housing market. But other forms of service inflation could remain elevated as demand remains strong and worker shortages put upward pressure on wages.

South African inflation also eased to 7.2% year-on-year in December. Importantly, core inflation – excluding volatile fuel, food and energy prices to provide a better view of underlying inflationary pressures – also declined slightly to 4.9%. The approval of Eskom's 18% tariff hike is a blow to consumers, but largely factored into most inflation forecasts already. Inflation should continue to moderate during the year, and this means the Reserve Bank can go easier on the rate hikes. This week's increase could be the last in the current cycle.



WEALTH

CHART 1: CONSUMER INFLATION, YEAR-ON-YEAR %



Source: Refinitiv Datastream

WAR AND ENERGY

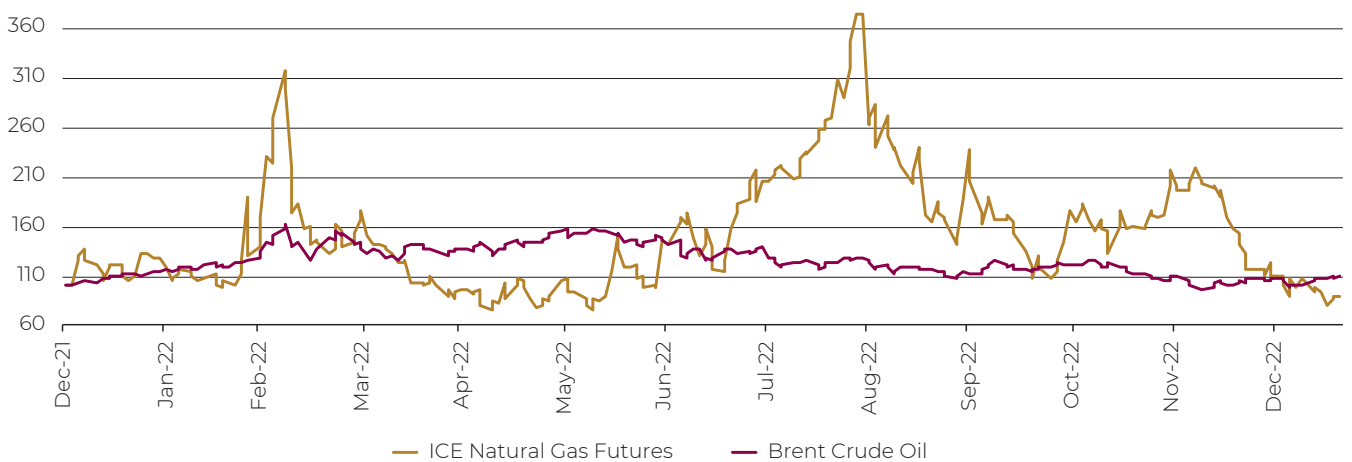
It is almost a year since Russia’s brutal invasion of Ukraine. While Ukrainians have fought back with tremendous courage, parts of the country remain occupied, and death and destruction are widespread. From a markets point of view, however, you wouldn’t say much has changed.

Natural gas and crude oil prices ended 2022 close to where they started the year. In other words, after spiking higher in wake of Russia’s invasion in February and the decision later in the year to shut gas pipelines, energy prices receded considerably in the last quarter. In the case of oil, global

supplies have not been materially hurt by the war and sanctions, since discounted Russian oil has been rerouted to China, India and elsewhere. In the case of gas, Europe could fill its storage tanks with gas shipped from America and elsewhere, due in part from reduced demand from lockdown-hit China. Luck has also helped in the form of a warm winter so far.

It means some of the worst-case economic scenarios related to 2022’s energy crisis have not come to pass, particularly for Europe. However, the war remains a wild card.

CHART 2: ENERGY PRICES IN 2022, REBASED TO 100



Source: Refinitiv Datastream

PONDERING POLICY

The standout feature of last year was record interest rate increases. Markets quickly and dramatically responded to the jump in short-term interest rates, with bonds and equities plunging, especially in the first half. Indeed, global equity benchmarks finished the year just shy of the traditional 20% measure of a bear market, while bond indices endured the worst year on record.

However, economics textbooks tell us that the real economy takes much longer to respond to changes in borrowing costs, and therefore most of the impact of last year's higher rates will be felt on the ground this year and global growth is likely to slow substantially.

The silver lining is that we are probably close to peak territory as far as policy rates go in most major economies.

However, central banks have made it clear that they will not declare victory prematurely. Just because inflation is falling, doesn't mean it will drop to the 2% target and stay there. Of particular concern to the likes of Jerome Powell at the Fed and Christine Lagarde at the ECB is tight labour markets putting upward pressure on wages and ultimately services inflation, as noted above.

Put differently, while the prices of globally traded items disrupted by the pandemic and war are normalising from

elevated levels, the prices of items related to the strength of the domestic economy still face upward pressure.

Therefore, though central banks will probably call a halt to rate increases in the coming months, the hurdle for starting to cut rates is high, probably higher than what is currently priced in. In the US, the market is currently pricing in Fed rate cuts in the second part of this year.

The one developed economy central bank that has been contrarian is the Bank of Japan (BoJ). It surprised markets shortly before Christmas by widening the trading range it targets for the 10-year government bond. While this is not the same as an interest rate increase, it is the next best thing for a central bank that has doggedly stuck to negative rates even as they've shot up in other countries. The lifting of the cap to 0.5% not only saw the 10-year bond yield jump, but also raised further questions over how long the policy of yield curve control will remain given that its leading proponent, BoJ Governor Haruhiko Kuroda, finishes his term in April. However, the BoJ pulled off another surprise last week by not announcing any further changes. This sets the scene for much debate and uncertainty in the weeks ahead, and places Kuroda's successor in an extremely difficult position.

DOLLAR DENOUEMENT

The dollar was on a tear for most of 2022, hitting a 20-year high in October. It has been drifting lower since then. By implication, other currencies went in the opposite direction to the dollar, and that includes the rand which weakened around 20% between January and November before regaining some ground.

A strong dollar is both a symptom and a source of global stress. It reflects the tighter monetary conditions in the US,

but also transmits the tightness to other countries as they are forced to raise rates. Similarly, the dollar tends to rise when there is fear on markets, but its strength also causes anxiety.

If US interest rates peak in the next few months, and the geopolitical situation calms, the dollar can remain on the backfoot and everyone else will breathe a sigh of relief

CHART 3: US DOLLAR INDEX



Source: Refinitiv Datastream

COVID PIVOT

The most dramatic change of the past month or so has been China's abandoning of its zero-Covid policy. With the economic pain seemingly becoming unbearable – economic growth slowed to a four-decade low of 3% in 2022 according to the official measure. The reality is probably worse – Beijing lifted most Covid-restrictions late last year. It has also taken steps to support the battered property sector and has eased up on regulatory crackdowns in other sectors.

This sets the stage for faster growth later this year, which will support the global economy at a time when the US is likely to slow but could also put renewed upward pressure

on energy prices. First, however, China must get through the current wave of Covid infections.

Longer term, the outlook for the Chinese economy remains constrained. Last week official data showed that deaths exceeded births in 2022 for the first time since the famine of the Great Leap Forward in the 1960s. Again, official data is probably a bit on the optimistic side. With a shrinking population, China loses a key growth engine. There isn't the pressing need to build more housing for instance. Growth will have to come from productivity, and this probably requires a more market-friendly approach than the one Beijing is embarking on under Xi Jinping's leadership.

IN THE DARK

South Africa's energy crisis escalated in December and January, and it doesn't appear that it will get better anytime soon. The simple reality is that Eskom's ageing and ailing power stations cannot cope, and the new mega-plants, Kusile and Medupi, are so badly built they are not faring much better. Only half of Eskom's installed capacity generated electricity last week, with the rest lost due to planned and mostly unplanned maintenance (i.e., breakdowns). The reality is also that government did not do nearly enough to supplement Eskom's supply with alternative sources over

the years despite the obvious need to do so. Thankfully, following regulatory changes, the private sector is increasingly able to take matters into its own hands and secure electricity supply for own use. However, this will not help in the very short term, and of course only businesses with capital can go this route. Small and informal businesses remain exposed. It is a series of bad decisions that got us to this point, and it cannot be unmade. All that counts now is that policymakers make the right decisions for the future.

POLITICS

December was a month of drama on the local political scene. We went from awaiting President Ramaphosa's imminent resignation one day to seeing him score a comprehensive win at the ANC Elective Conference. The latter means we are likely to see broad policy continuity, including the need for fiscal consolidation as we are likely to see in next month's Budget Speech. The most pressing matter on Ramaphosa's plate is the electricity crisis, but there is no shortage of other problems to tackle. One hopes that with a stronger mandate from ANC party members he can act with greater urgency and make tough decisions where needed.

Although the local political scene seems to be calming down, the opposite is happening in the US. This impacts investors at an arcane corner of US fiscal legislation called the debt ceiling. Congress authorises federal government spending in the US, and like its counterparts across the world, the US Treasury supplements tax revenues with borrowing to fund that spending. But unique to the US, Congress separately applies a limit to how much the Treasury is allowed to borrow. It used to routinely lift this debt ceiling

without a fuss, but in recent years it has become a political football. The debt ceiling has now been reached and the Republicans that have taken over the House of Representatives want to use it to extract concessions from the Biden Administration. Particularly worrying is that rise of an extremist wing in the Republican caucus complicates these negotiations greatly.

If the debt ceiling is not lifted by mid-year, the federal government could start missing payments on salaries, pensions and most ominously for investors, interest on bonds. This amounts to a default, even if it's due to technical-legal reasons and not the fundamental ability to pay as in the case of most other high-profile defaults, such as Argentina's. Given the central role of US bonds in the global financial system, such a default could cause chaos, but in truth, no one knows for sure. It would be unfamiliar territory, and therefore difficult for markets to price in. Needless to say, it can cause substantial volatility in the months ahead, as seen during the last time there was a big debt ceiling fight in 2011.

JANU-WORRIES AND JANU-RALLIES

So here we are in the month of Janus, with markets also displaying two-faced behaviour. On the one hand, a long list of worries, fears and concerns. On the other hand, equities and bonds are off to a flying start, locally as well as globally.

On balance, it does appear that some of the big downside scenarios investors fretted over last year are now less likely. The probability of a soft or soft-ish landing, where inflation declines but economic growth does not collapse, has improved. Importantly, valuations reset across markets last year, and many markets started the year attractively priced.

It means the rally since the start of the year is therefore not completely built on sand. There is some substance to a more optimistic view than even just a few weeks ago. It is dangerous to extrapolate from the first weeks of January

into the rest of the year (despite the old adage "as goes January, so goes the year"), but it is also worth pointing out that the month-to-date return from equities is already ahead of what cash will deliver for the year as a whole. Remember also that local markets always respond to global developments, even if it means ignoring domestic issues. Stage 6 loadshedding has not prevented local assets from rallying.

Whether this is the start of a global bull market or just another bear market rally we'll only know after the fact. What we do know from history is that markets tend to turn long before the economy does, and that missing out on such bursts can have a detrimental impact on long-term returns. Hence the importance of remaining invested even when times are uncertain.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 725.0	-0.40%	4.69%	-15.69%	-11.58%
United States	S&P 500	US\$	3 973.0	-0.65%	3.46%	-16.64%	-11.38%
Europe	MSCI Europe	US\$	1 872.0	0.00%	8.08%	-10.56%	-10.00%
Britain	FTSE 100	US\$	9 631.0	0.39%	6.83%	-3.59%	-6.63%
Germany	DAX	US\$	1 463.0	0.07%	11.17%	11.20%	-12.76%
Japan	Nikkei 225	US\$	205.1	0.38%	3.03%	-9.54%	-15.76%
Emerging Markets	MSCI Emerging Markets	US\$	1 036.0	0.58%	8.37%	-15.91%	-17.52%
Brazil	MSCI Brazil	US\$	1 507.0	-1.25%	3.29%	5.02%	-2.90%
China	MSCI China	US\$	72.6	1.26%	13.54%	-13.25%	-15.99%
India	MSCI India	US\$	779.5	0.15%	1.10%	-7.75%	-10.20%
South Africa	MSCI South Africa	US\$	449.0	-3.65%	6.65%	-1.10%	-9.48%

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	79 270.0	-0.08%	8.52%	7.54%	3.98%
All Share	All Share (Total Return)	Rand	13 469.0	-0.05%	8.59%	12.48%	8.71%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	32 894.7	-0.56%	6.93%	11.65%	8.15%
TOP 40/Large Caps	Top 40	Rand	12 348.0	0.00%	9.31%	13.91%	9.76%
Mid Caps	Mid Cap	Rand	20 614.0	-0.29%	3.80%	5.46%	4.57%
Small Companies	Small Cap	Rand	29 983.0	-0.50%	2.06%	9.77%	8.64%
Resources	Resource 20	Rand	6 348.4	-0.47%	10.51%	17.37%	7.93%
Industrials	Industrial 25	Rand	21 045.0	0.66%	11.16%	7.43%	6.95%
Financials	Financial 15	Rand	10 930.0	-0.80%	3.12%	13.64%	11.30%
Listed Property	SA Listed Property	Rand	1 703.9	-0.36%	0.70%	1.18%	3.89%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US\$	79.5	-0.11%	3.26%	-16.06%	-15.20%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	877.0	-0.45%	2.28%	6.60%	5.18%
Government Bonds	BESA GOVI	Rand	864.9	-0.44%	2.30%	6.54%	5.12%
Inflation Linked Bonds	BESA CILI	Rand	324.5	-1.12%	-0.52%	3.70%	6.02%
Cash	STEFI Composite	Rand	509.3	0.13%	0.39%	5.61%	5.37%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	87.6	2.76%	1.90%	12.35%	-0.42%
Gold	Gold Spot	US\$	1 926.0	0.31%	5.59%	5.30%	4.62%
Platinum	Platinum Spot	US\$	1 042.0	-2.07%	-2.89%	7.53%	0.29%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.14	-1.66%	-0.63%	-6.97%	-11.18%
ZAR/Pound	ZAR/GBP	Rand	21.21	-2.97%	-2.92%	1.65%	-2.40%
ZAR/Euro	ZAR/EUR	Rand	18.58	-1.76%	-1.92%	-2.41%	-7.36%
Dollar/Euro	USD/EUR	US\$	1.09	-0.92%	-1.83%	4.31%	3.67%
Dollar/Pound	USD/GBP	US\$	1.24	-1.32%	-2.37%	8.92%	9.73%
Dollar/Yen	USD/JPY	US\$	0.01	1.28%	-1.23%	12.50%	13.49%

Source: I-Net, figures as at 20 January 2023

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WEALTH

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