

INVESTMENT NOTE

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A TIME OF TRANSITIONS



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Springtime in the south looms, while in the north autumn approaches. Of course, the weather cares little for human-made calendars, and cold or heat might linger too long or come too early, depending on where you are and what your preference is. But ultimately, the seasons do change. This is a time of transitions.

The big transition on global markets is the turning point in global interest rates after a period where they were at elevated levels across most economies (China and Japan being notable exceptions).

When interest rates rise, a few things happen. The cost of servicing existing debt often rises, reducing disposable income for households and margins for companies. The cost of new borrowing or rolling over existing debt rises, potentially discouraging the purchases of homes, cars and capital equipment. It raises the hurdle for the expected return any new investment must generate before being considered profitable and worthwhile. These effects slow economic growth, though they are somewhat offset by the fact that savers now earn higher returns on their cash. Slower growth in turn weighs on company profits,

and therefore the bond and share prices of these firms should adjust to reflect the new reality. Since all asset classes compete for capital with one another, high interest rates make cash and cash-like investments more attractive. Bond, real estate and equity valuations tend to adjust lower to reflect the relative loss of attractiveness. Finally, since not all countries raise interest rates at the same time and at the same pace, the gap between countries' interest rates shift, resulting in exchange rate movements. Money tends to flow to where risk-adjusted returns are highest, weakening the 'sending' currency and strengthening the 'receiving' currency.

Most of these things happened with the 2021 to 2023 global surge in interest rates. The notable exception is that we did not see much of the first item on the list in the US since most mortgages have fixed interest rates these days. Most homeowners did not experience rising interest burdens, but it also meant few were prepared to sell their homes and lose their low mortgage rates. This blunted the impact of the rate hikes, and the US economy remained resilient, but also effectively froze the housing market. There were other factors behind the resilience, including fiscal stimulus and a



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surge in immigrants which boosted the labour force and kept wage increases under control. Nonetheless, there are parts of the US economy facing the squeeze from higher interest rates and that will benefit from relief, including lower income consumers, small business, and homebuilders. The same goes for other countries where central banks have already cut rates, and in places like South Africa where the Reserve Bank is likely to do so soon.

DROPPING DOLLAR

The US had a stronger recovery from Covid than other major economies, and therefore its central bank, the Fed, could hike interest rates to higher levels to combat inflation than some of its peers.

The result was a jump in the US dollar against the euro, the yen, the yuan and others, including the rand. The dollar has probably also benefited from its traditional role as a haven amid rolling geopolitical crises.

A strong dollar is rarely good for the rest of the world and is probably not very good for the US economy either. A strong dollar means that servicing the trillions in dollar denominated debt owed by governments and companies outside the US becomes more expensive. It tends to put

As interest rates start falling, the effects listed above should start reversing. The impact on markets is perhaps most pronounced and, since markets tend to price in the future before it happens, most immediate. We've therefore seen a rally in interest-rate sensitive assets of all stripes across the globe, as well as currency moves. Let's look at a few of these in turn.

upward pressure on inflation and interest rates in vulnerable countries, and it throws sand in the gears of global commerce since most trade is still invoiced and settled in dollars.

The past few weeks have seen the trade-weighted dollar index losing ground, however, as shown in chart 1. The index is back to early 2022 levels, reversing most of the gains it made when US interest rates started rising. Seen in a bigger perspective, it still looks quite strong, trading above its long-term average of 97. There is probably room for further declines, but it will depend on how the growth and interest rate outlook of the US evolves compared to those of its major trading partners.

CHART 1: US DOLLAR INDEX



Source: LSEG Datastream

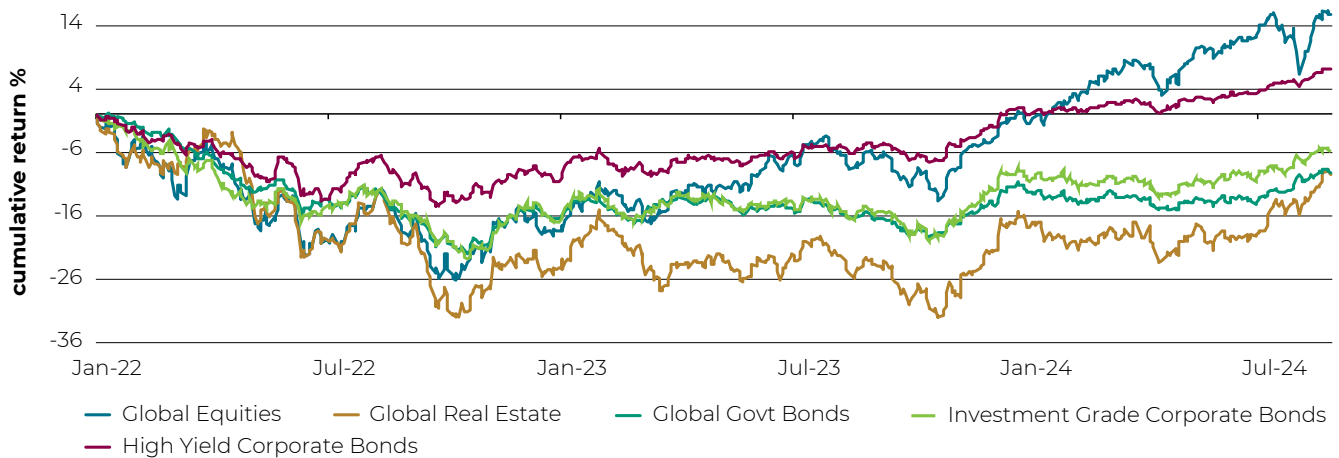
Bonds rallied (meaning yields fell) in the first few days of August as US growth fears resurfaced and equity markets slumped. Bonds performed their traditional role as a portfolio diversifier, something that was possible because yields are at respectably high levels today, unlike in 2022, when bonds and equities crashed simultaneously. While equities have recovered, bond yields have not, pointing to the deeper rate cuts now priced in. The benchmark US 10-year Treasury yield fell from 4% to 3.9% during the month, while the two-year yield also fell to 3.9%, ending the 25-month inversion of the yield curve, one of the longest stretches ever.

Global bond indices have not yet recouped the 2022 losses, except for high yield corporate bonds. But for new investors

that is not a bad thing, and most South African investors only started paying attention to global bonds after the sell-off, i.e. after yields had risen.

Real estate endured a torrid time when rates rose, since it is by nature a leveraged business. Coming soon after Covid-related disruptions to property use patterns, notably the office sector, the sentiment shock was pronounced. As chart 2 shows, global listed property (the FTSE EPRA/NAREIT Developed Index) fell more than bonds and equities when the Fed started hiking rates in 2022. With a cutting cycle now coming into view, the sector gained 12% in July and August, but this has not put it back to pre-2022 levels yet.

CHART 2: US CONSUMER PRICE INDEX



Source: LSEG Datastream

Despite this remarkable turn of events, many Americans feel bleak about the state of the economy according to survey data. It is worth remembering that most people don't care about the change in the price level (i.e. the inflation rate) but where the price level is. While the inflation rate is the same as in early 2021, the price level is 20% higher. It is also about 14% higher than if the pre-Covid trend remained in place. This cost-of-living shock will likely still be an election issue come November, even if the inflation rate continues declining.

Importantly, from the Fed's point of view, consumers' expectation of future inflation remains roughly where it was before the pandemic. People mostly see this jump in the price level as a one-off event, not one that will be sustained year after year. The Fed therefore has a green light to start cutting interest rates at its policy meeting next month. The only question is by how much. The more resilient the economy, the fewer the Fed will cut over the next few months. Rates will fall much less in a soft landing scenario than if a hard landing occurred.

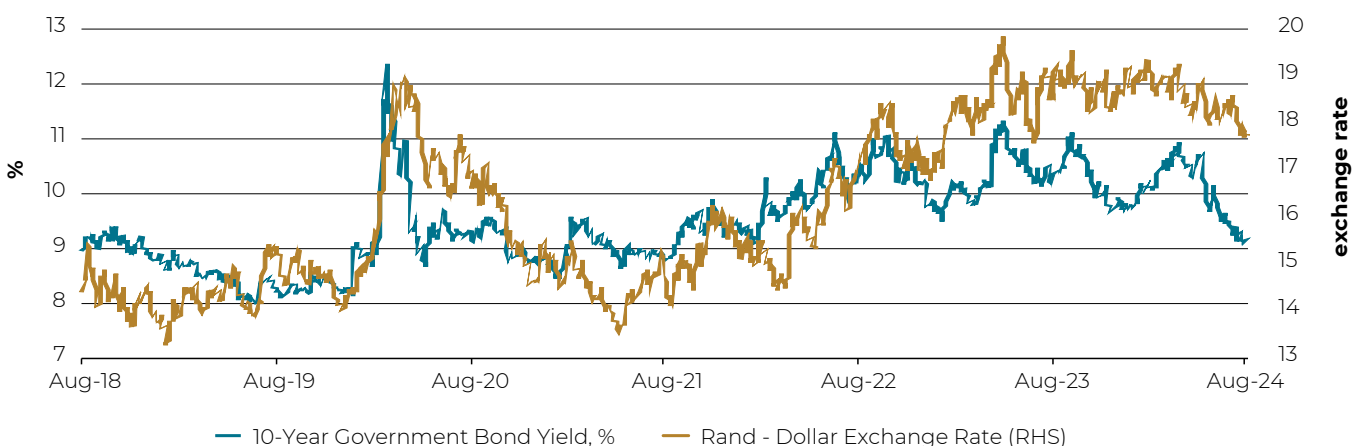
A DIFFERENT PICTURE

In China, the world's number two economy, a very different growth, inflation and policy picture is emerging. The economy has been trading water by its own standards. Most other countries would be happy with 4% to 5% GDP growth, but not China. Many business models were based on ongoing rapid growth. For instance, headline annual growth in retail sales was only 2.7% in July in nominal terms, compared to an average of around 10% in the years before the pandemic. The point is not that 2.7% is a terrible number; it isn't. But imagine how many shopping malls were built on the assumption of continued double-digit sales growth. And

how many steel mills operated on the assumption that more and more shopping malls would be built? How much of all of this was underpinned by debt which must now be serviced with reduced incomes? In other words, while this is not a hard landing as traditionally defined, it will feel a lot like it to many Chinese households and business owners.

One of the main reasons for this dramatic slowdown is the popping of the property bubble which has negatively impacted household wealth and confidence and evaporated about a quarter of housing market activity compared to last year. The property implosion shows little sign of stabilising.

CHART 3: CHINA HOUSING ACTIVITY



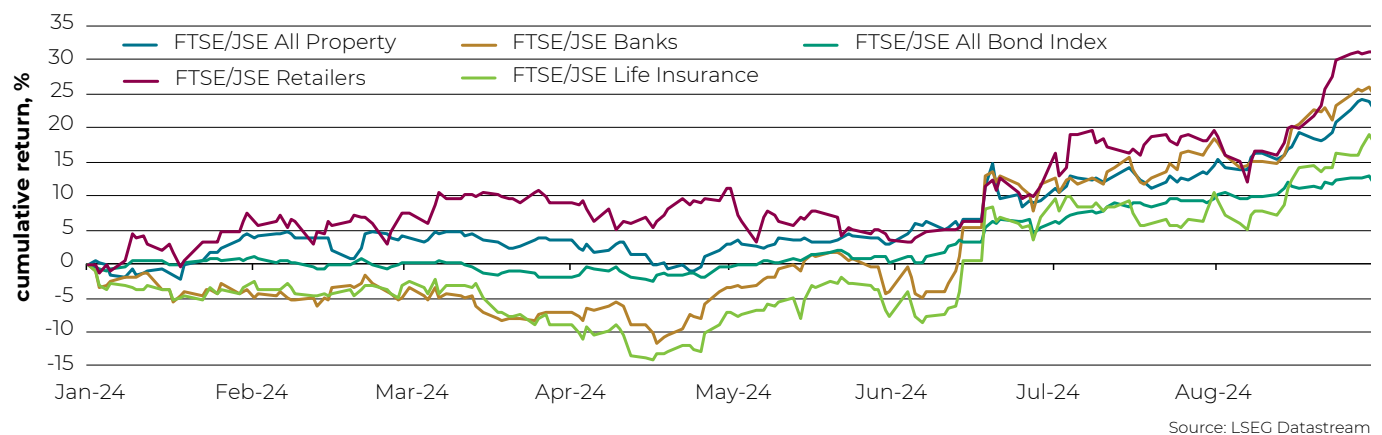
Source: LSEG Datastream

An improved growth outlook in turn should give rise to a somewhat better fiscal outlook as tax revenues should rise. The October Medium-Term Budget will update the fiscal projections, but declining debt risks mean investors should demand a smaller premium for lending to the South African government. This translates to somewhat lower bond yields, all else equal, which further reduces the debt burden, and

lowers borrowing costs in the private sector, potentially further stimulating the economy.

On the JSE, the big winners have also been the interest rate-sensitive sectors, including banks, life insurers, retailers and listed property.

CHART 4: SA INTEREST RATE-SENSITIVE INVESTMENTS IN 2024



However, it hasn't been plain sailing across all local sectors. Resources shares are under pressure, except for the gold miners who benefit from a record price for the precious metal. Unfortunately, there aren't many gold miners left on the JSE, and having largely mined out most of its major ore bodies, South Africa has dropped from being the global number one producer to only number nine. The slowdown

in Chinese economic activity, specifically construction, has weighed on iron ore and industrial metals, while platinum group metal (PGM) prices reflect uncertainty over global demand growth for conventional vehicles amid competition from electric cars. (PGMs are primarily used to reduce emissions of toxic gasses in internal combustion engines).

JUICE IN THE TANK

After the rally in domestic assets, it's reasonable to ask whether there is any more juice left in the tank. Expectations of a global soft landing are probably largely priced in, while the positive surprise of the government of national unity is similarly reflected in local markets, as are the looming SARB rate cuts. Further rallies require more positive surprises, either globally or locally, while disappointment on the pace and extent of rate cuts could still unwind some of the positive sentiment.

However, valuation remains on the side of South African assets, while the various improvements in the economic fundamentals – lower inflation, lower interest rates, no loadshedding, rising confidence – can be mutually reinforcing and can snowball in a good way after years where one crisis compounded another. We've already seen growth forecasts by major banks being upgraded in recent months. Future upgrades should provide fresh impetus to local market valuations.

It is always natural to anchor off the lows, which will make current levels seem very high. Take the rand for instance. Compared to a level of almost R20 to the dollar in May last year, the end-August close of R17.76 seems very strong. But not that long ago, in August 2022, the rand traded between R14 and R15 to the dollar, around 20% stronger than today.

Similarly, despite the rally in South African bonds this year, the All Bond Index has not returned to pre-Covid levels yet. Of the 12% year-to-date return, 5% was due to higher bond prices, with the remainder being interest income. Even if the improvement in bond prices stall, yields are still high enough to offer solid real returns to patient investors. As always, the patience part is crucial. This time of year, a string of cold days can be interspersed with a few hot ones, and vice versa. Markets similarly don't go up or down in straight lines.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 661.0	0.30%	2.49%	15.53%	22.36%
United States	S&P 500	US\$	5 648.0	0.23%	2.28%	18.41%	25.09%
Europe	MSCI Europe	US\$	2 219.0	0.41%	3.74%	9.85%	15.57%
Britain	FTSE 100	US\$	10 996.0	-0.10%	2.21%	11.68%	15.66%
Germany	DAX	US\$	1 801.0	0.33%	4.16%	13.71%	17.79%
Japan	Nikkei 225	US\$	264.4	-0.47%	1.43%	11.44%	19.62%
Emerging Markets	MSCI Emerging Markets	US\$	1 100.0	-0.09%	1.38%	7.42%	11.34%
Brazil	MSCI Brazil	US\$	1 504.0	-2.08%	5.54%	-16.44%	-6.12%
China	MSCI China	US\$	56.6	-0.28%	0.93%	2.06%	-5.73%
India	MSCI India	US\$	1 124.5	1.58%	0.85%	21.96%	38.14%
South Africa	MSCI South Africa	US\$	464.0	-0.85%	3.34%	11.81%	16.00%

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	83 750.0	-0.71%	1.19%	8.92%	11.29%
All Share	All Share (Total Return)	Rand	15 098.0	-0.68%	1.38%	11.41%	15.61%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	36 986.5	-0.68%	1.29%	11.47%	16.24%
TOP 40/Large Caps	Top 40	Rand	13 603.0	-0.85%	1.01%	10.50%	13.74%
Mid Caps	Mid Cap	Rand	24 301.0	-1.02%	0.45%	11.54%	20.15%
Small Companies	Small Cap	Rand	39 782.0	1.17%	5.43%	21.80%	28.03%
Resources	Resource 20	Rand	4 837.7	-4.66%	-9.69%	-0.49%	0.59%
Industrials	Industrial 25	Rand	24 833.0	-0.30%	4.03%	11.85%	13.18%
Financials	Financial 15	Rand	15 604.0	1.45%	5.66%	20.86%	28.78%
Listed Property	SA Listed Property	Rand	2 307.4	2.56%	8.28%	23.79%	36.45%

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\$	77.8	-0.63%	2.36%	-0.84%	3.00%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 056.8	0.00%	2.35%	12.37%	18.17%
Government Bonds	BESA GOVI	Rand	1 040.6	-0.02%	2.32%	12.26%	18.04%
Inflation Linked Bonds	BESA CILI	Rand	370.9	0.96%	2.22%	6.19%	11.56%
Cash	STEFI Composite	Rand	579.0	0.16%	0.67%	5.65%	8.56%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	76.9	-2.64%	-5.02%	-0.09%	-10.55%
Gold	Gold Spot	US\$	2 503.0	-0.36%	3.56%	21.33%	29.22%
Platinum	Platinum Spot	US\$	926.0	-3.84%	-4.63%	-6.18%	-5.12%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.83	-0.60%	2.04%	2.65%	4.78%
ZAR/Pound	ZAR/GBP	Rand	23.40	0.04%	0.04%	-0.43%	1.58%
ZAR/Euro	ZAR/EUR	Rand	19.69	0.70%	-0.01%	2.58%	3.65%
Dollar/Euro	USD/EUR	US\$	1.10	1.82%	-1.55%	0.36%	-0.91%
Dollar/Pound	USD/GBP	US\$	1.31	0.69%	-1.73%	-3.25%	-3.25%
Dollar/Yen	USD/JPY	US\$	0.01	1.21%	-2.56%	3.64%	-0.07%

Source: I-Net, figures as at 30 August 2024

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