

INVESTMENT NOTE

6 FEBRUARY 2023

THE PROBLEM WITH GOOD NEWS



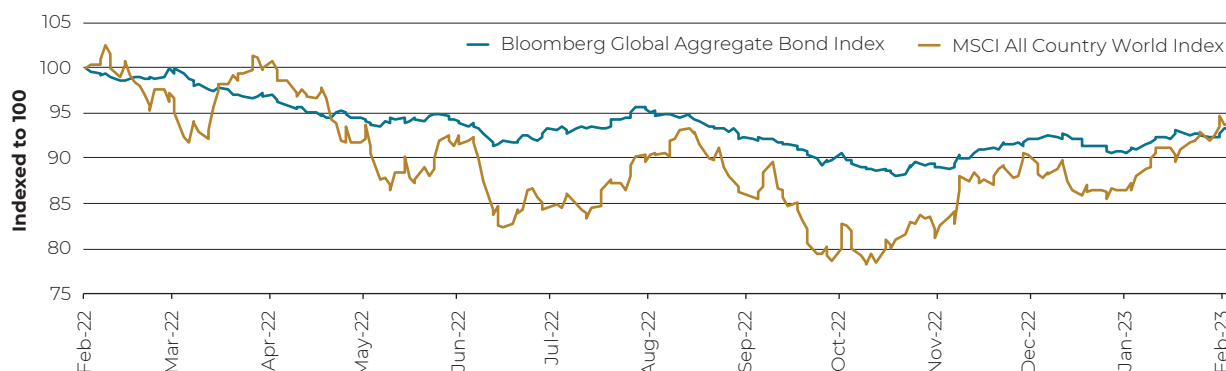
IZAK ODENDAAL

OLD MUTUAL MULTI-MANAGERS

At the start of the year, there is greater optimism that the worst-case scenarios feared in 2022 will not come to pass. Inflation is receding, though unevenly, which limits upward pressure on interest rates. The US dollar has pulled back, providing relief to many emerging markets and US multinationals. The energy crisis has subsided, particularly in Europe, as the war in Ukraine grinds seemingly into stalemate. And China's abrupt U-turn on its Covid policies means a much better growth outlook for the world's second largest economy.

The International Monetary Fund therefore upgraded its global growth forecast for 2023 slightly. It still expects economic growth to slow this year, not least because of the lagged impact of record interest rate increases in 2022. But it does not think the slowdown will be as severe as it did a few months ago. It is projecting global growth of 2.9% in 2023, with an improvement to 3.1% in 2024. These numbers are below the long-term average of 3.5%, but ahead of annual global population growth of around 1%.

CHART 1: GLOBAL BONDS AND EQUITIES, US DOLLARS



Source: Refinitiv Datastream



WEALTH

Markets are always very quick to discount known information, and the improved outlook has seen a strong rebound in equities and bonds after a dire 2022. The equity rally is probably stealing the spotlight – the MSCI All Country World Index is up 8% so far this year – but it is the bond rally that has a bigger impact on the real economy. Even as central banks continue to hike short-term policy interest rates, market-determined yields are declining, easing borrowing costs for households and businesses (bond yields and prices move in opposite directions).

In the US for instance, borrowing costs for the riskiest (high yields) corporates have dropped from 9% in October to 8% today. This does not undo the impact of tightening during the course of 2022 but offers relief. Similarly, the rate on a 30-year mortgage has fallen from a peak of 7.3% to 6.4%. Mortgage applications are already picking up slowly.

Also offering considerable relief is energy prices, particularly natural gas, and food prices, easing the big cost-of-living squeeze. This will leave consumers with a bit of extra spending power this year, helping the economic outlook. Good news.

THERE'S GOOD NEWS AND BAD NEWS

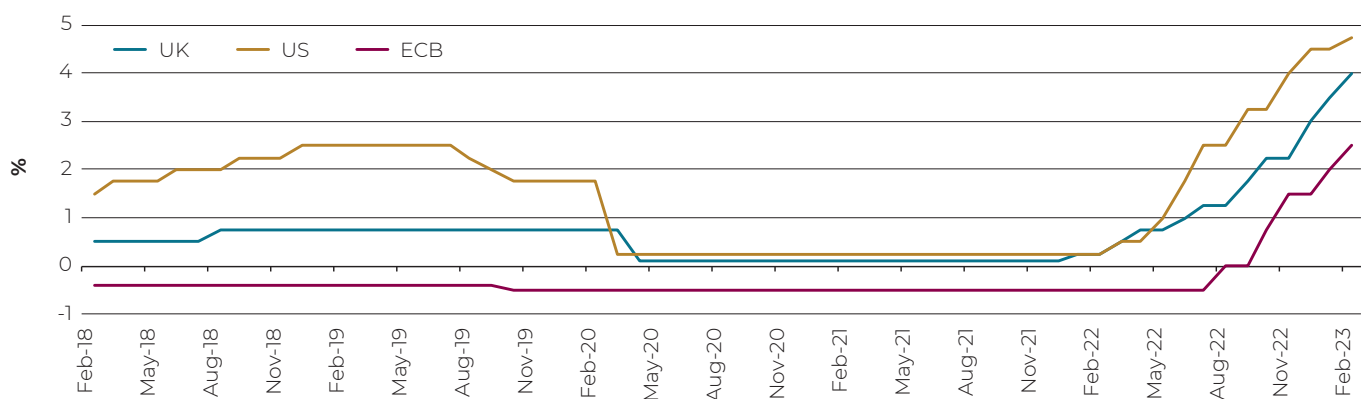
Good news, however, is not always unambiguously good for investors. This is true in a general and specific sense. In general terms, when there is too much optimism, investors tend to overpay and end up with disappointing returns. A gloomy environment is often the best to be shopping around for investment bargains and earning above-average returns.

But more specifically, the good news on the economic front complicates life for central banks. While inflation is declining from elevated levels, resilient economic growth and low unemployment make it difficult to have confidence that

inflation will decline all the way to the 2% target and stay there. In the Eurozone for instance, last week's inflation data shows a better-than-expected decline in headline inflation, but core inflation, excluding energy and food, is still high at 5%. In the US core inflation is falling, but not uniformly across underlying categories. Service inflation is still high and sensitive to wage growth.

Therefore, it is useful to reflect on three major central banks who held monetary policy meetings last week. All three hiked rates in line with market expectations, so the interesting part is their commentary on the outlook.

CHART 2: POLICY RATES IN THE US, UK AND EUROZONE



Source: Refinitiv Datastream

Starting with the US Federal Reserve, the messaging was the same as before. The 25 basis points increase, though smaller than the previous meeting, is not the last as the Fed remains careful not to declare victory against inflation prematurely.

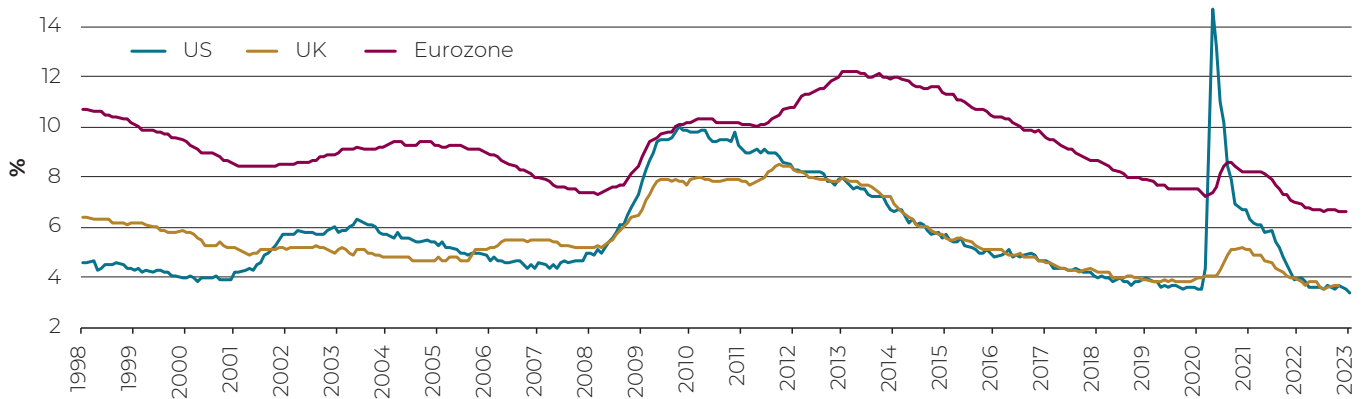
However, there was a slight change in tone, suggesting the Fed is growing more comfortable with the current outlook and not too worried about easing financial conditions. It will probably pause once it gets its policy rate to around 5% (in March or May) and then assess the situation. This is priced in.

The disconnect is still that the market expects the Fed to cut rates in the second half of the year, while Fed officials are adamant they have no such plans. The market seems convinced that inflation will quietly go away as economic growth cools but doesn't collapse, a soft landing, in other words.

Inflation is declining in sectors most affected by commodity prices and pandemic-related supply chain disruptions, but it is too soon to say with certainty that it is the case across the entire US economy.

The Fed, and other developed market central banks, remains concerned that low unemployment and labour shortages will put upward pressure on wages and ultimately, service inflation. Various measures of wage growth remain high but are at least not accelerating. Data on Friday showed that US employment growth exceeded expectations in January with 517 000 jobs created against expectations of a slowdown to only 185 000. The unemployment rate fell to 3.4%, a level last seen in 1969. Again, good news for the economic growth outlook, not necessarily for inflation.

CHART 3: UNEMPLOYMENT RATES, %



Source: Refinitiv Datastream

GOT GAS

Across the Atlantic, the outlook for the Eurozone economy has improved substantially compared to a few months ago as Europe is halfway through winter with sufficient gas to meet household and industrial needs. Natural gas prices have fallen below where they were on the eve of the invasion. Energy price relief will help consumers and businesses, and lower headline inflation rates. But for the European Central Bank (ECB), a better growth outlook raises non-energy inflation risks. Eurozone unemployment is at the lowest

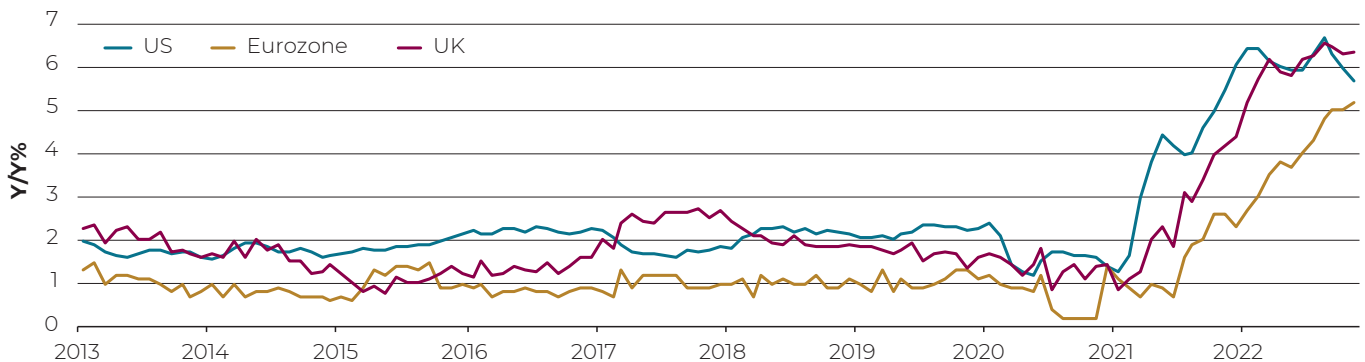
level since the founding of the monetary bloc, leading ECB President Christine Lagarde to note that inflationary pressures are still "alive and kicking" in the Eurozone. The ECB messaging is therefore still hawkish, pointing to further hikes ahead. But euro money markets are also pricing in cuts later this year and in fact the market moved the expected rate path lower despite the lack of dovish signals from the ECB and the fact that a Eurozone recession is no longer the baseline scenario.

CRUEL BRITANNIA

Meanwhile, Bank of England Governor Andrew Bailey probably has the most difficult job in central banking (his Japanese counterpart gives him a run for his money, but under very different circumstances). A recession is still very much on the cards, and the UK is the only G7 economy forecast to contract this year by the International Monetary Fund, struggling with labour shortages, a greater dependence on natural gas than other European countries and general Brexit-related disruptions. The Bank of England's forecasts

are even gloomier. But despite this and some encouraging signs on the inflation front – indeed the Bank forecasts inflation falling below 2% mid-2024 – Bailey and company are pressing ahead with rate increases as insurance against further nasty inflation surprises. The implication is that the insurance premium can be cancelled if those inflation risks don't materialise, and the BoE could be the first major central bank to start cutting rates.

CHART 4: CORE INFLATION IN THE US, UK AND THE EUROZONE



Source: Refinitiv Datastream

As for South Africa, in contrast to the more optimistic global outlook, the new year in South Africa kicked off with sustained high levels of loadshedding that look set to be a feature for the next 12 to 24 months. This will be a severe drag on economic growth.

Fortunately, there are two silver linings. A better global growth outlook always helps South Africa, a small open economy. And spending on alternative sources of energy is likely to accelerate dramatically as policy and regulatory obstacles are removed.

The IMF expects growth of only 1.2% this year and 1.3% next year, which will barely keep up with population growth. However, it does not point to a collapse in economic activity. The South African economy remains an underperformer relative to the obvious potential, but also remains resilient in the face of a seemingly never-ending series of shocks.

Locally too, interest rates are at or near their peak. A combination of easing inflation, the weak economic outlook, a better global inflation picture and a less menacing US dollar reduce the need for the Reserve Bank to hike again.

SQUARING THE CIRCLE

So how do we make sense of this? Local bonds and equities have also rallied this year, but are largely following global markets rather than domestic developments. Global bonds and equities are both rallying even as central bankers say their job is not quite done. The market is saying they've done enough and will reverse course soon. We will have to wait and see who is right.

The gains in equities this year have come from a re-rating, in other words a rising price: earnings ratio, not earnings growth. Earnings growth forecasts continue to be downgraded to only 2.5% this year for the MSCI All Country World Index, rising to 9% for 2024. Re-ratings are driven by sentiment,

which can change, while long-term returns are driven by earnings growth.

Therefore, though the market rally is welcome after a tough 2022, we should not get carried away. The lowest quality investments that fell the most last year have increased the most this year. This is typical of a market driven by short-covering, FOMO (fear of missing out) and momentum. While fundamentals are improving, we are not out of the woods yet, and rebalancing after a strong run (or big declines) is usually a good idea to ensure portfolios remain appropriately diversified without having to make a big asset allocation call in an uncertain environment.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 821.0	1.26%	1.29%	8.37%	-7.57%
United States	S&P 500	US\$	4 136.0	1.60%	1.45%	7.71%	-7.62%
Europe	MSCI Europe	US\$	1 910.0	1.38%	1.54%	10.28%	-6.05%
Britain	FTSE 100	US\$	9 526.0	-1.04%	-0.49%	5.67%	-6.95%
Germany	DAX	US\$	1 508.0	1.69%	2.03%	12.94%	-8.05%
Japan	Nikkei 225	US\$	209.7	-0.55%	-0.16%	5.37%	-11.49%
Emerging Markets	MSCI Emerging Markets	US\$	1 039.0	-1.14%	0.78%	8.68%	-14.13%
Brazil	MSCI Brazil	US\$	1 480.0	-3.90%	-4.88%	1.44%	-9.09%
China	MSCI China	US\$	71.3	-4.91%	-0.31%	11.43%	-11.95%
India	MSCI India	US\$	746.5	-0.66%	-0.06%	-3.17%	-12.17%
South Africa	MSCI South Africa	US\$	448.0	-1.32%	1.59%	6.41%	-8.76%

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	80 241.0	-0.68%	0.96%	9.85%	6.96%
All Share	All Share (Total Return)	Rand	13 637.0	-0.68%	0.96%	9.94%	11.82%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	33 311.7	-0.25%	1.24%	8.29%	9.97%
TOP 40/Large Caps	Top 40	Rand	12 500.0	-0.92%	0.89%	10.66%	12.93%
Mid Caps	Mid Cap	Rand	20 975.0	1.04%	1.73%	5.62%	7.01%
Small Companies	Small Cap	Rand	30 811.0	1.75%	2.49%	4.88%	12.57%
Resources	Resource 20	Rand	6 099.9	-3.45%	-0.85%	6.19%	7.30%
Industrials	Industrial 25	Rand	21 711.0	-0.39%	1.15%	14.67%	12.56%
Financials	Financial 15	Rand	11 299.0	1.66%	2.51%	6.60%	11.57%
Listed Property	SA Listed Property	Rand	1 710.1	1.95%	2.09%	1.07%	4.21%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US\$	79.4	0.05%	0.13%	3.10%	-14.63%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	886.6	0.29%	0.41%	3.39%	5.64%
Government Bonds	BESA GOVI	Rand	874.4	0.30%	0.42%	3.42%	5.61%
Inflation Linked Bonds	BESA CILI	Rand	322.9	-0.30%	-0.03%	-1.00%	3.51%
Cash	STEFI Composite	Rand	510.7	0.13%	0.06%	0.66%	5.49%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	79.9	-7.75%	-5.95%	-7.05%	-12.15%
Gold	Gold Spot	US\$	1 865.0	-3.27%	-2.20%	2.25%	3.27%
Platinum	Platinum Spot	US\$	975.0	-3.56%	-3.56%	-9.13%	-5.98%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.47	-1.47%	-0.32%	-2.50%	-12.63%
ZAR/Pound	ZAR/GBP	Rand	21.07	1.23%	1.80%	-2.28%	-1.52%
ZAR/Euro	ZAR/EUR	Rand	18.87	-0.91%	0.21%	-3.45%	-7.48%
Dollar/Euro	USD/EUR	US\$	1.08	0.93%	0.56%	-0.93%	5.56%
Dollar/Pound	USD/GBP	US\$	1.21	2.82%	2.02%	0.36%	12.81%
Dollar/Yen	USD/JPY	US\$	0.01	1.01%	0.83%	0.05%	14.09%

Source: I-Net, figures as at 3 February 2023

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.



WEALTH

Old Mutual Wealth is brought to you through several authorised Financial Services Providers in the Old Mutual Group who make up the elite service offering. This document is for information purposes only and does not constitute financial advice in any way or form. It is important to consult a financial planner to receive financial advice before acting on any information contained herein. Old Mutual Wealth and its directors, officers and employees shall not be responsible and disclaims all liability for any loss, damage (whether direct, indirect, special or consequential) and/or expense of any nature whatsoever, which may be suffered as a result of or which may be attributable, directly or indirectly, to the use of, or reliance upon any information contained in this document.