MARKET MATTERS

FED UP?

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Meetings of the US Federal Reserve's Open Markets Committee (FOMC) are always a big deal for global markets, as they determine the path of the world's most important interest rate. Virtually all financial assets are in some way priced directly or indirectly off the Fed's policy interest rate, the federal funds rate. Most meetings end up being uneventful, but occasionally a slight shift in the Fed's policy outlook can cause a sizable market response. Last week was one of those occasions.

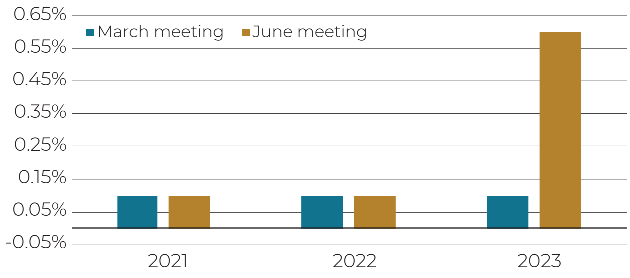
Before getting into the details, it should be noted that although the Fed is effectively central bank for the world, its mandate is explicitly US focused. It aims to achieve an average inflation rate of 2% over time (which means it will need to let inflation rise above 2% to make up for the time it spent below target) and maximum employment of Americans. While in recent years it has become more conscious of how its actions reverberate around the world, those reverberations are only fully considered to the extent that they impact the US.

Last week's meeting took place against a particularly interesting background, and while there was no announced change in policy, change seems to be coming sooner than expected. The US economy is recovering from the Covid-19 shock and growing strongly. The FOMC statement noted the progress on vaccinations and improvement in economic activity and employment, but also that the sectors most adversely affected by the pandemic are still struggling. It pointed out again that the rise in inflation is expected to be transitory. As a result, the statement concludes that its policy rate will remain close to zero and its monthly purchases of $120 billion in Treasuries and mortgage-backed securities will remain until maximum employment is judged to have been achieved and inflation is on track to moderately exceed 2% "for some time".

GOING DOTTY

However, the accompanying quarterly "dot plot", which shows the projections of 18 individual Fed officials and the heads of regional reserve banks (not all of whom are voting members of FOMC), suggests that most officials now believe rates will rise sooner than the market expected. The median dot on the plot now suggests two rate hikes in 2023 though there is clearly still a wide range of views among officials. Three months ago, the dot plot still pointed to unchanged rates in 2023.

CHART 1: MEDIAN 'DOT PLOT' PROJECTIONS OF FEDERAL FUNDS RATE



Source: US Federal Reserve

That is still a long time away, but markets will start – and have already started – pricing in that day. As a result, investments linked to a lower-for-longer interest rate view came under pressure: stocks sold off and the rand ended the week well above R14 per dollar.

The inflation outlook is crucial here. Inflation has been rising faster than expected as the reopening of the economy has resulted in various shortages and bottlenecks. In simple terms, demand has recovered sooner than supply can respond. For instance, hotels that stood empty for months suddenly find themselves dealing with an influx of customers, and prices have increased to reflect this. Similarly, cars are in short supply and used car prices jumped by 7% in the month of May alone. As the Fed suggests, these increases are likely to be temporary as supply rises to meet demand. The main thing is that inflation expectations remain anchored, to use the jargon. In other words, if most people believe the inflation spike is temporary, their behaviour won't fundamentally change. However, if they start expecting inflation to remain at these levels, or even accelerate, people will start responding accordingly. They will bring forward big-ticket purchases, increasing demand. Workers will demand higher wage increases. Landlords will jack up rental escalations. Longer-term contracts will incorporate higher annual increases. This is how inflation becomes self-fulfilling.

If this happens, higher interest rates could be needed to short-circuit the vicious cycle, as was the case in the late 1970s.

For the time being, the Fed's dots suggest inflation to average 3.4% this year, up from 2.4% in March, but that it will settle closer to 2% over the next few years.

Meanwhile, the US economy is expected to have a bumper year. The dots show an upgraded growth forecast of 7% this year, declining to 3.3% next year and 2.4% in 2023. These are all above the longer-term potential rate of 1.8%.

TIMING THE TAPER

Long before the Fed hikes rates, it will scale down or taper its monthly bond buying (quantitative easing) programme, eventually halting it altogether. Fed Chair Powell indicated that the committee was now discussing this, but would not commit to timing. An announcement will probably be made before the end of this year.

On one level, a normalisation in monetary policy is very good news. That is if the US and global economies no longer need emergency support that should be supportive for a broad range of investments. However, as we've seen during the course of the year, it is not necessarily a smooth adjustment. There are investments – bonds and some specific types of equities – whose high valuations depend on continued low interest rates and who are vulnerable.

It would, however, be simplistic to say that equity markets have only gone up because of low interest rates, when earnings growth has been phenomenal after bottoming out mid-2020. It is similarly simplistic to say that bond yields are low because of the Fed's purchases. After all, the 10-year government bond yield has tripled since August (from 0.5% to 1.5%) despite the Fed's ongoing large-scale bond purchases. There is always nuance.

Similarly, though emerging markets are potentially at risk of destabilising capital outflows, if US monetary policy is tightened because of stronger growth, they can benefit from the export side. It depends.

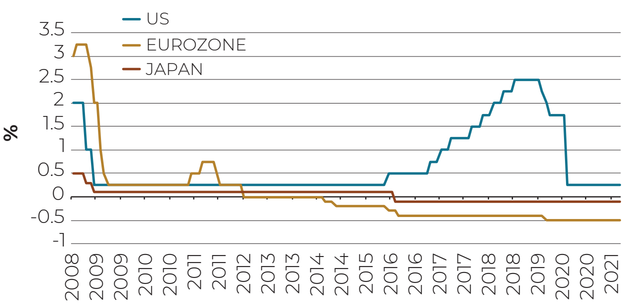
HAVE WE SEEN THIS MOVIE BEFORE?

The 2013 to 2018 period can give us clues, but today's scenario is not exactly the same. After slashing interest rates to near-zero levels in 2008, and then embarking on several rounds of quantitative easing, by 2013 the Fed was starting to consider scaling back stimulus. Then Fed chair Ben Bernanke infamously set off the so-called taper tantrum in May 2013 when he suggested a tapering of bond purchases could be on the horizon. US – and global – bonds sold off and yields rose. Emerging market currencies started falling. Though violent, the taper tantrum was fairly short-lived.

However, for emerging markets, the cat was out of the bag. The billions of dollars that flowed in during the 'search for yield' era between 2009 and 2013 would now be at risk as investors eyed not just the end of quantitative easing, but also the eventual hiking of the federal funds rate. In 2014, a grouping of emerging markets that included South Africa earned the nickname Fragile Five as they were particularly vulnerable to capital flight. One consequence was that the SA Reserve Bank started raising interest rates even though domestic growth was starting to slow. The US dollar also appreciated markedly on a trade-weighted basis in the second half of 2014 and again in 2016.

In the end, the Fed's policy tightening was extremely slow. The Fed hiked rates for the first time only in December 2015, and only by 25 basis points. The next hike only came a year later, and it then proceeded very gradually. But by late 2018, the market started worrying that even the slow and steady increase in rates was overdoing it. Equities and bonds sold off sharply, and credit markets showed signs of cracking. The Fed stopped the hikes and soon started cutting. At no point was there a serious risk of inflation, despite low interest rates, declining unemployment and billions of dollars of liquidity injected into the financial system. This pre-pandemic experience will in all likelihood inform the Fed's path in the months and years ahead.

CHART 2: CENTRAL BANK POLICY INTEREST RATES, %

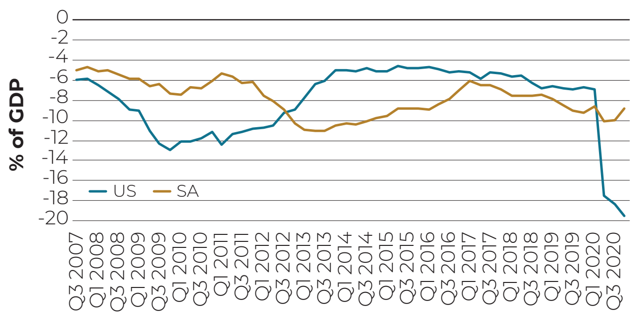


Source: Refinitiv Datastream

DOLLAR DRIFT?

As US interest rates will in all likelihood rise faster than those of Europe and Japan, this could lift the US dollar at the expense of other currencies. However, the extent of any possible dollar appreciation is likely to be countered by the fact that the US twin deficit – the combined current account and fiscal deficit – is at a record level in double digits. These deficits don't matter nearly as much to the US as they would for other countries since the US has the world's reserve currency. But they are not irrelevant

CHART 3: TWIN DEFICITS: CURRENT ACCOUNT PLUS BUDGET BALANCE AS % OF GDP



Source: Refinitiv Datastream

PORTFOLIO IMPLICATIONS

So what should investors at the southern tip of Africa do about these decisions being taken thousands of miles away in Washington, D.C.?

The first point is that as markets reprice expectations for US interest rates, things could get quite choppy. Don't panic if there is volatility. Big bear markets happen when there is a recession (or one on the horizon) and that is clearly not the case now.

Secondly, as noted earlier, some investments can be hurt by rising rates, but others should respond favourably to the conditions that give rise to higher interest rates as long as we are talking about decent rates of real economic growth and not sustained high inflation. This implies that equity remains the preferred asset class, but that returns are more likely to come from earnings growth than rising valuations.

Thirdly, there is no reason to expect US short-term interest rates to eventually settle at particularly high levels. In the last decade, the highest they could reach – briefly – was 2.5%. Rates in Europe and Japan will probably rise by even less, if they ever do. Longer-term interest rates should reflect this. In other words, global fixed income is unlikely to be a particularly attractive option.

Finally, in terms of South African investments, we note that valuation is still on the side of domestic bonds, equities and property. South Africa seems less vulnerable than during the previous period of tightening US monetary policy. Inflation is under control and expected to remain close to the Reserve Bank's 4.5% target, with inflation expectations also anchored close to that level. South Africa's combined twin deficit is smaller than in 2013/14 when we became a member of the Fragile Five. This is because our current account is in surplus, even though the fiscal deficit is much larger. Importantly, unlike the earlier period, South Africa's political and policy mix is also moving in the right direction.

This in turn implies that we shouldn't expect substantial increases in short-term interest rates, which renders money market an unattractive longer-term investment.

Finally, since the future could still unfold in many unexpected ways, appropriate portfolio diversification remains important.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 954.0	-1.96%	-0.74%	9.81%	33.30%
United States	S&P 500	US$	4 166.0	-1.91%	-0.90%	10.92%	33.74%
Europe	MSCI Europe	US$	2 023.0	-3.21%	-1.65%	9.95%	30.85%
Britain	FTSE 100	US$	9 688.0	-3.76%	-2.96%	9.73%	25.30%
Germany	DAX	US$	1 732.0	-3.40%	-2.26%	-2.94%	33.95%
Japan	Nikkei 225	US$	262.8	-0.45%	-0.22%	-6.27%	25.73%
Emerging Markets	MSCI Emerging Markets	US$	1 361.0	-1.52%	-1.09%	5.42%	36.78%
Brazil	MSCI Brazil	US$	2 039.0	0.64%	5.54%	8.69%	36.85%
China	MSCI China	US$	107.3	-1.07%	-2.47%	-1.07%	23.42%
India	MSCI India	US$	758.9	-2.23%	-0.40%	12.43%	59.44%
South Africa	MSCI South Africa	US$	493.0	-6.45%	-7.68%	9.56%	40.06%

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	65 635.0	-3.08%	-3.43%	10.48%	21.68%
All Share	All Share (Total Return)	Rand	10 386.0	-3.08%	-3.40%	12.08%	24.85%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	26 113.0	-3.43%	-3.60%	12.63%	26.58%
TOP 40/Large Caps	Top 40	Rand	9 367.0	-3.16%	-3.68%	10.96%	23.06%
Mid Caps	Mid Cap	Rand	17 579.0	-2.46%	-2.52%	15.90%	31.39%
Small Companies	Small Cap	Rand	22 768.0	-1.13%	0.26%	32.60%	63.23%
Resources	Resource 20	Rand	4 437.2	-7.32%	-9.91%	8.58%	29.64%
Industrials	Industrial 25	Rand	17 837.0	0.38%	1.28%	13.31%	18.34%
Financials	Financial 15	Rand	8 279.0	-4.72%	-3.43%	9.70%	26.57%
Listed Property	SA Listed Property	Rand	1 461.0	-1.06%	2.96%	18.78%	20.74%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	541.1	-0.99%	-0.84%	-3.16%	2.72%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	793.7	-1.29%	0.69%	4.58%	14.47%
Government Bonds	BESA GOVI	Rand	783.7	-1.30%	0.67%	4.50%	14.27%
Inflation Linked Bonds	BESA CILI	Rand	296.0	-0.43%	-0.08%	9.22%	15.08%
Cash	STEFI Composite	Rand	472.5	0.07%	0.18%	1.71%	4.06%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	73.5	1.13%	6.54%	41.37%	75.02%
Gold	Gold Spot	US$	1 773.0	-6.59%	-6.49%	-6.39%	2.66%
Platinum	Platinum Spot	US$	1 063.0	-8.04%	-10.07%	-0.65%	30.43%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.36	-4.51%	-4.31%	2.32%	21.68%
ZAR/Pound	ZAR/GBP	Rand	19.80	-2.27%	-1.36%	1.41%	9.60%
ZAR/Euro	ZAR/EUR	Rand	17.03	-2.48%	-1.36%	5.39%	14.96%
Dollar/Euro	USD/EUR	US$	1.19	1.68%	2.77%	2.69%	-5.88%
Dollar/Pound	USD/GBP	US$	1.38	2.21%	2.86%	-0.76%	-10.18%
Dollar/Yen	USD/JPY	US$	0.01	0.51%	0.58%	6.69%	3.04%

Source: I-Net, figures as at 18 June 2021

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