# MARKET MATTERS

## THE DELTA BLUES

DAVE MOHR AND IZAK ODENDAAL | OLD MUTUAL MULTI-MANAGERS

19 JULY - 23 JULY 2021

The physical and metaphorical dust from the devastating looting in KZN and Gauteng is settling. Much has already been written about the causes and consequences, both of which are still uncertain, and much ink will no doubt still be spilled. We therefore turn our attention to some of the broader global developments shaping the outlook for South African investors. These ultimately matter more for local portfolios.

## THE JAB IS FAB

Last week saw one of the biggest equity market wobbles we've had in a while, completely unrelated to the unrest. Rather, global investors were briefly spooked by the relentless spread of the Delta variant of the coronavirus, particularly in the US, but also in the UK and Continental Europe. The more the virus spreads, the further away the day is that life fully returns to normal. Even if governments do not tighten restrictions, voluntary reductions in movement can still result in business activity scaling back.

The good news is that vaccination seems very effective in combating serious cases of Delta-related Covid. The overwhelming number of hospitalisations and deaths in the US and UK are unvaccinated individuals. After enormous initial progress, vaccination rates in the US have tapered off. It seems those who want the jab have received it. The remainder are choosing not to do so, often for inexplicable political reasons (the lowest vaccination rates are reported in counties that voted Trump in the last election). Hopefully they can be persuaded otherwise.

Meanwhile in South Africa, the third wave of coronavirus outbreaks, also led by the Delta variant, seems to have peaked, while our vaccination drive is also finally picking up real momentum. More than 6 million individuals have received at least one jab, and the daily vaccination rate is up to 250 000 people. This is obviously important for health reasons but should also boost consumer confidence. Crucially, it could also set the stage for the return of international tourists if the country can be removed from "red lists". As a result, lockdown restrictions have been eased, which will give a boost to the battered restaurant and alcohol sectors. President Ramaphosa also reinstated the R350 per month special grant for the next seven months, as well as a range of other measures to provide some relief to businesses struggling in the wake of the Level 4 lockdowns and the unrest.

## THE DELTA OF DELTA

The Delta variant, first identified in India, was named after the fourth letter of the Greek alphabet, because it was the fourth variant to be designated a variant of concern. In mathematics delta is also used as the symbol measuring the difference or change between two variables. In finance, delta is often the shorthand for a growth rate.

Growth rates also have a delta (the second derivative, to be technical about it). In other words, growth can accelerate or decelerate, but still be positive. In terms of global economic growth, it seems as if the frantic pace of the last year is slowing. Global growth is still likely to be above average for the next 12 to 18 months, and thereafter revert to the longer term mean of about 3% (as per International Monetary Fund forecasts).

That is fine. Some investors might have gotten ahead of themselves in their expectations of global economic growth, but as long as it remains positive, it can support expanding company profits.

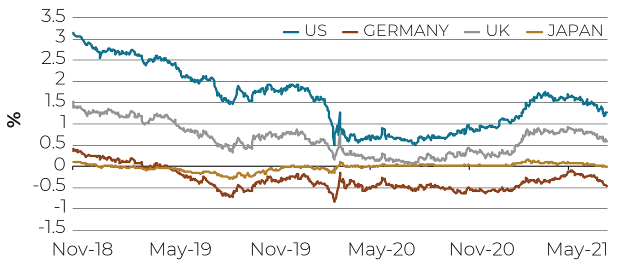
It is recessions, after all, that cause bear markets. Among last week's news was the overlooked announcement by a committee of greybeards at the US National Bureau of Economic Research that the US recession of 2020 was officially the shortest, but also the deepest on record.

The US economy contracted rapidly in February and March, but was growing again by April. Why it took them so long to make the pronouncement is unclear, but it is yet another reminder of how unusual the events of the past year and a half have been. However, it does mean that the experience of the past year has been completely in line with previous bear markets. The S&P500 plunged in late February, losing 34% before bottoming on 23 March and rallying thereafter. Yes, the policy support from the Federal Reserve and US Federal Government was unprecedented, but the equity market behaved as it did in previous cycles. The market turned before the economy did and rallied even as unemployment remained elevated and things still seemed very gloomy. These turning points cannot be forecast, however. You need to be in the market to fully benefit.

## CONUNDRUM

Meanwhile, global bond yields have continued drifting lower, perhaps reflecting that the growth rate of the global economy is turning somewhat lower. Nonetheless, the absolute levels of developed market bond yields are extremely low considering where inflation and economic growth currently are. To use the US as an example, the 10-year bond yield sunk below 1.3%, while inflation is 5% and GDP growth is running at an annualised rate of 4.2% in the third quarter, according to the New York Fed's 'nowcast' model.

**CHART 1: DEVELOPED MARKET 10-YEAR BOND YIELDS, %**




Source: Refinitiv Datastream

In some ways, the decline in bond yields harks back to Allan Greenspan's famous conundrum comment. Back in February 2005, the then Federal Reserve Chair expressed his bemusement at the fact that long bond yields were falling even as he was pushing up short rates.

Of course, the Fed today is nowhere near hiking rates yet, but with strong US (and global) growth and elevated inflation, the decline in bond yields is a bit of a head scratcher. It could be that bond investors are pessimistic about longer-term growth and inflation prospects.

Or it means that the structural demand for bonds from relatively price-insensitive buyers is so large the bond market's signals about future growth and inflation expectations is overwhelmed. The truth is probably in between.

These price-insensitive investors include central banks of course, but also large pension and insurance companies, and banks. Demographic trends also play a role as retirees increase allocations to bonds, often automatically. The world remains awash in excess savings, and it can't all go into the equity market, for regulatory and risk management reasons. These factors seem to act as a gravitational pull on bond yields and explain why the US 10-year bond yield, for instance, never managed to rise above 3.2% in the last 10 years.

It does mean that for investors unconstrained by such regulations, equities remain the more attractive asset class globally. That is certainly the perspective of investors sitting at the southern tip of Africa.

The forward earnings yield (inverse of the price: earnings ratio) of the MSCI All Country World Index is 5%, much higher than the long bond yield of any developed country. Even the dividend yield of 1.6% is higher. (Companies don't pay out all their earnings as dividends, retaining a portion to reinvest in future growth, buy back shares, or for other purposes.)

**CHART 2: GLOBAL EQUITY EARNINGS YIELD, %**


Source: Refinitiv Datastream

And with a supportive macroeconomic backdrop, companies are reporting extremely strong profit numbers in the current results season (for the second quarter). Earnings per share growth of US S&P 500 companies that have reported so far are running well ahead of expectations at 99% year-on-year, according to JP Morgan. While this is off the depressed base of the second quarter of 2020, it remains impressive. For Eurostoxx600 companies the growth rate is much lower at 29%. Japanese companies are also ahead of consensus, reporting 46% earnings per share growth. In other words, shareholders are being rewarded for staying invested over a very uncertain period.

## LOW FOR EVEN LONGER

One of the price-insensitive bond buyers, the European Central Bank (ECB), could end up increasing the substantial current pace of purchases. It recently announced the results of a lengthy policy framework review, the first in almost two decades. Without getting bogged down in the details, it will change its inflation target from not-quite 2% to a symmetrical 2%. In other words, the target is not a ceiling. Inflation can overshoot, and indeed should overshoot if it has been below target for a long time. As a result, the ECB tweaked its policy stance as follows: interest rates are to remain at their present or lower levels until inflation reaches 2% and is projected to stabilise at 2% over the medium term. In other words, not any time soon. Neither the ECB's current inflation projection nor measures of inflation expectations suggest the target will be reached.

Therefore, the long-standing €20 billion a month bond-buying programme will continue until shortly before it starts raising interest rates, while the 'emergency' bond-buying programme (with a total size of €1,850 billion) will run until at least the end of March 2022 and until "the coronavirus crisis phase" is over.

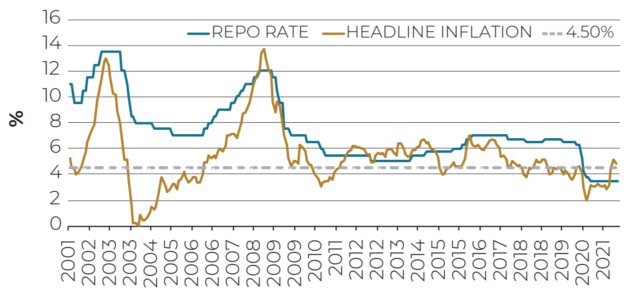
This is despite the recovery in the Eurozone economy being "on track", by the ECB's estimate. One would rather not imagine what would happen if the recovery were off track.

## REPO UNCHANGED

Staying with the world of central banking, our own Reserve Bank's Monetary Policy Committee kept the repo rate unchanged at 3.5% in a unanimous decision. This was not a surprising decision given a still-fragile domestic economy and muted inflation outlook.

The Reserve Bank's inflation forecast for 2021 is slightly higher at 4.3%, largely due to higher assumed fuel and food inflation, but slightly lower in 2022 at 4.2%. The 2023 outlook was unchanged at 4.5%. In other words, inflation is set to be close to the 4.5% mid-point of the Bank's inflation target over the medium term. June inflation print was slightly lower in May, at 4.9% year-on-year, but food inflation remains elevated at 7% and could have been a contributing factor to the recent unrest. Excluding volatile food and fuel prices, core inflation was 3.2% year-on-year.

**CHART 3: SA REPO RATE AND INFLATION, %**




Source: Refinitiv Datastream

In terms of the economic growth outlook, the MPC statement noted that the looting and destruction would negate the better-than-expected first quarter performance, leaving the 2021 growth forecast unchanged at 4.2%. The forecast for the next two years was also left unchanged at around 2% per year. In other words, the Bank does not expect the destruction in KZN and Gauteng to disrupt the business cycle upswing currently underway. This makes sense, but of course there is still considerable uncertainty over how these events will impact business confidence and investment spending over the medium term.

An important inclusion in the MPC statement is worth quoting in full: "Better anchored expectations of future inflation could keep interest rates lower for longer, and can be realised by achieving a stable public debt level, increasing the supply of energy, moderating administered price inflation and keeping wage inflation low into the recovery. Such steps will enhance the effectiveness of monetary policy and its transmission to the broader economy."

In other words, progress on fiscal consolidation, economic reform and realistic wage growth can lead to a positive feedback loop where interest rates are lower, but also more effective at stimulating economic growth. Stronger economic growth in turn accelerates fiscal consolidation (more tax revenue) and reduces pressure on administered prices. This is an enticing prospect at a time when many are feeling gloomy about the outlook for the economy.

## THE UNCERTAINTY PRINCIPLE

In a number of fields of study, including physics, delta is also sometimes used to denote uncertainty.

In our world of making investment decisions today, in order to achieve a favourable outcome at some future point, uncertainty always looms large. This is because of the inherent unpredictability of the future, but also because of gaps in our knowledge of the present. For investors, the past few months reiterate the importance of being humble in what we think we know about the world, not panicking in the face of surprising events, and acknowledging the value of being appropriately diversified.

## EQUITIES - GLOBAL

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Global | MSCI World | US$ | 3 072.0 | 1.55% | 1.82% | 14.20% | 33.10% |
| United States | S&P 500 | US$ | 4 412.0 | 1.96% | 2.65% | 17.47% | 36.34% |
| Europe | MSCI Europe | US$ | 2 044.0 | 0.94% | 0.89% | 11.09% | 24.79% |
| Britain | FTSE 100 | US$ | 9 662.0 | 0.13% | -0.75% | 9.43% | 22.10% |
| Germany | DAX | US$ | 1 745.0 | 0.58% | 0.40% | 13.40% | 22.89% |
| Japan | Nikkei 225 | US$ | 249.2 | -2.04% | -3.83% | -6.19% | 17.04% |
| Emerging Markets | MSCI Emerging Markets | US$ | 1 311.0 | -2.16% | -4.65% | 1.55% | 21.61% |
| Brazil | MSCI Brazil | US$ | 1 942.0 | -2.26% | -4.10% | 3.52% | 18.49% |
| China | MSCI China | US$ | 100.2 | -3.73% | -8.58% | -7.59% | 4.16% |
| India | MSCI India | US$ | 764.1 | 0.36% | 1.21% | 13.20% | 42.03% |
| South Africa | MSCI South Africa | US$ | 476.0 | -1.86% | -3.25% | 5.78% | 20.51% |

## 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 | 68 064.0 | 2.31% | 2.74% | 14.57% | 21.39% |
| All Share | All Share (Total Return) | Rand | 10 785.0 | 2.34% | 2.81% | 16.38% | 24.61% |
| JSE Capped SWIX | Capped SWIX (Total Return) | Rand | 26 612.0 | 1.38% | 1.30% | 14.78% | 24.45% |
| TOP 40/Large Caps | Top 40 | Rand | 9 761.0 | 2.50% | 3.01% | 15.62% | 22.92% |
| Mid Caps | Mid Cap | Rand | 17 815.0 | 1.42% | 1.41% | 17.46% | 31.18% |
| Small Companies | Small Cap | Rand | 22 422.0 | 1.28% | -0.27% | 30.58% | 63.89% |
| Resources | Resource 20 | Rand | 4 870.0 | 3.21% | 5.80% | 19.17% | 26.26% |
| Industrials | Industrial 25 | Rand | 18 175.0 | 2.51% | 2.61% | 15.46% | 20.40% |
| Financials | Financial 15 | Rand | 8 178.0 | 0.69% | -2.04% | 8.36% | 26.32% |
| Listed Property | SA Listed Property | Rand | 1 452.4 | 0.64% | -1.00% | 18.08% | 23.50% |

## FIXED INTEREST - GLOBAL

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| US Aggregate Bond Index | Bloomberg Barclays | US$ | 544.7 | 0.08% | 0.71% | -2.52% | 1.24% |

## FIXED INTEREST - SOUTH AFRICA

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| All Bond | BESA ALBI | Rand | 791.2 | -0.37% | -0.71% | 4.25% | 11.44% |
| Government Bonds | BESA GOVI | Rand | 781.8 | -0.34% | -0.66% | 4.24% | 11.46% |
| Inflation Linked Bonds | BESA CILI | Rand | 291.2 | -0.90% | -0.21% | 7.46% | 15.98% |
| Cash | STEFI Composite | Rand | 474.2 | 0.07% | 0.24% | 2.07% | 3.93% |

## COMMODITIES

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Brent Crude Oil | Brent Crude ICE | US$ | 74.1 | 0.69% | -1.20% | 42.50% | 72.33% |
| Gold | Gold Spot | US$ | 1 807.0 | -1.26% | 1.57% | -4.59% | -3.73% |
| Platinum | Platinum Spot | US$ | 1 095.0 | -4.12% | -0.09% | 2.34% | 18.51% |

## CURRENCIES

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| ZAR/Dollar | ZAR/USD | Rand | 14.85 | -2.61% | -3.86% | -1.06% | 12.21% |
| ZAR/Pound | ZAR/GBP | Rand | 20.42 | -2.74% | -3.28% | -1.67% | 4.02% |
| ZAR/Euro | ZAR/EUR | Rand | 17.48 | -2.53% | -3.16% | 2.68% | 10.57% |
| Dollar/Euro | USD/EUR | US$ | 1.18 | 0.00% | 0.51% | 3.56% | -1.69% |
| Dollar/Pound | USD/GBP | US$ | 1.37 | 0.15% | 0.38% | -0.35% | -7.62% |
| Dollar/Yen | USD/JPY | US$ | 0.01 | 0.42% | -0.51% | 7.00% | 3.45% |

Source: I-Net, figures as at 23 July 2021