MARKET MATTERS

POLICY PRIORITIES IN A PERSISTENT PANDEMIC

20 SEPTEMBER - 24 SEPTEMBER 2021

Central bank policymaking in the age of Covid was initially straightforward. Central banks acted in unison to cut rates, and many also injected substantial amounts of liquidity into their financial systems. The world saw synchronised easing in response to an unprecedented crisis.

Today individual countries face different problems, and therefore central bank policy priorities are diverging. This potentially creates challenges for investors. Last week, Norway's Norges Bank became the first developed market central bank to hike rates since the pandemic struck, but this investment note will focus on the policy stance of three other central banks: the People's Bank of China (PBOC), the US Federal Reserve (the Fed), and the South African Reserve Bank (SARB).

NOT SO GRAND ANYMORE

The challenge for the PBOC is not so much Covid-19, though China continues to experience sporadic outbreaks that it responds to with harsh localised lockdowns. It's rather that the chickens are coming home to roost following three decades of breakneck growth in the property sector.

Giant property developer China Evergrande has been a source of concern for investors and policymakers for some time, but things came to a head last week when it failed to make a scheduled interest payment on one of its offshore bonds. Its total liabilities extend to some $300 billion, including outstanding loans and bonds and money owed to contractors. Thousands of property buyers who have put money down are still waiting for yet-to-be-completed apartments. The company even has a financial arm that sold wealth management products stuffed full of its own bonds to retail investors and employees.

Borrowing is part and parcel of property development anywhere, and works well as long as incomes are growing and debt can be rolled over easily and cheaply. However, as debt increases, so do risks. The Chinese government has attempted to rein in excessive borrowing across the economy for several years, and last year specifically put in place debt limits for property developers.

It has also been trying to cool the property market, including through caps on mortgage lending. As far back as 2017, President Xi Jinping warned that "houses are for living in, not speculation". Yet China's biggest cities are among the most expensive in the world when house prices are compared to household incomes. Too many people are priced out of the property market, something at odds with the "common prosperity" doctrine that now seems to dominate Beijing's thinking (and which also sits behind the crackdowns on the technology sector earlier this year).

This has squeezed developers' income. On the other side of the equation, interest rates in the corporate bond market have risen sharply, making borrowing prohibitively expensive. The net result is that Evergrande is now in serious trouble.

CHART 1: CHINA EVERGRANDE SHARE PRICE

Source: Refinitiv Datastream

This is where the PBOC and other policymakers tread a tricky path. They want the overheated property market to cool down. At the same time, housing is the biggest store of wealth for Chinese households, much more than pensions or investment funds. A collapse in house prices would be a massive negative wealth shock. Meanwhile, China also wants to avoid the "moral hazard" of bailing out a profligate borrower like Evergrande. Many lenders showered the company with debt because they assumed Beijing would bail them out if anything went wrong. This meant an important aspect of market discipline was missing. But allowing the company and others like it to fail chaotically could result in all kinds of unpredictable consequences, much like the failure of Lehman Brothers in September 2008.

NOT WITH A BANG BUT A WHIMPER

Nonetheless, Evergrande is not Lehman Brothers, because China's financial system operates differently. The banks are state-owned and will support the property developers if that is what Beijing wants. Political connections also still play a big role in who gets state support and who doesn't.

China has restructured several large firms without major problems before, but Evergrande would be the biggest and most delicate. The market consensus seems to be that China can contain this without major fall-out, and equities and commodities stabilised after initial sharp declines.

Nonetheless, foreign investors in Evergrande bonds and equity will likely endure big losses. Unlike central banks in the West, the PBOC cares much less about the stock and bond markets, since these are not viewed as primary channels for policy transmission. The PBOC is also not an independent central bank, but very much an organ of state. It injected liquidity into the money market, but has not done anything more.

Beyond the immediate concerns of market contagion, there is a broader question: is this the end of the epic Chinese property boom? If so, the country will lose an important growth driver even if there is no disorderly market reaction. China only introduced private home ownership in the 1990s, and the real estate sector quickly expanded to meet the surging demand from an urbanising society. Since the real estate sector also contributed to rapid economic growth, it sowed the seeds of its own prosperity as demand for housing (for living and speculation) grew. And since land is owned by the state, local authorities could fund large infrastructure projects by selling land, instead of raising taxes. With or without an Evergrande collapse, the sector's growth tailwinds have weakened substantially as urbanisation has slowed and population growth is going into reverse.

END OF THE ROAD?

By the estimate of Harvard Professor Ken Rogoff, the Chinese real estate sector broadly defined accounts for 29% of GDP, a number that exceeds any other major country in the world by some distance. Only Spain in 2006 came close, and that was at the peak of the global housing bubble. In most other developed countries, the number now sits between 10% and 20%. All real estate booms end eventually, and it might be China's turn now. If so, it implies much slower economic growth in the years ahead.

TRANSITORY?

In the US, the big question remains the path of inflation. A strong recovery in demand has collided with fractured supply chains to send inflation rates spiking higher. The Fed has long argued that this will fade in the months ahead as base effects ease and the distortions caused by lockdowns and reopening recede. This is also more or less what is priced into markets. The problem is that the longer Covid continues to disrupt the normal way of conducting business, the more likely it is that inflation will behave in unexpected ways. It is also extremely difficult to know what is normal these days. Some things might have changed permanently.

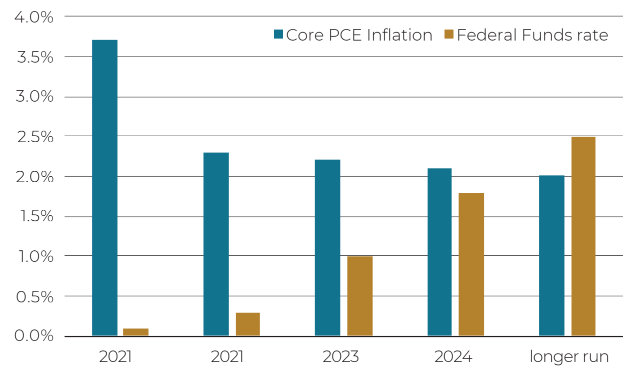
Inflation is not bad for company profits per se. After all, one person's inflation is another's income. But the valuation that investors have put on global shares – the amount they are prepared to pay for each dollar worth of profit – is elevated partly because they expect inflation and interest rates to be well behaved over time. If this view changes, equities and bonds can sell off. Bond yields are already very low and do not compensate for even moderate levels of future inflation.

TAPER, BUT NO TANTRUM

Hence the importance of last week's Fed monetary policy meeting, and the accompanying projections from officials (colloquially known as the dot plot).

As expected, the Fed's statement indicated that it was ready to commence a gradual reduction or tapering of its monthly bond purchases, perhaps as early as November if "progress continues broadly as expected". The Fed still expects strong growth in the US over the next three years that will lower unemployment back towards pre-pandemic levels. The dot plot projections also still suggest core inflation returning to an average close to 2% next year, even though the forecast for this year has been marked up substantially from 3% to 3.7%. In other words, the Fed is sticking to the view that inflation is "transitory".

CHART 2: MEDIAN INTEREST RATE AND INFLATION EXPECTATION OF FED OFFICIALS, %



Source: Federal Reserve

Notably, the dots suggest a faster pace of fed funds rate increases than was the case in June. They now point to a first hike of 0.25% next year, with three hikes in each of the next two years. In the unspecified long run, the fed funds rate is expected to settle at 2.5%. Yet markets barely blinked. There has been no repeat of the 2013 "taper tantrum" and no rate hike fright either.

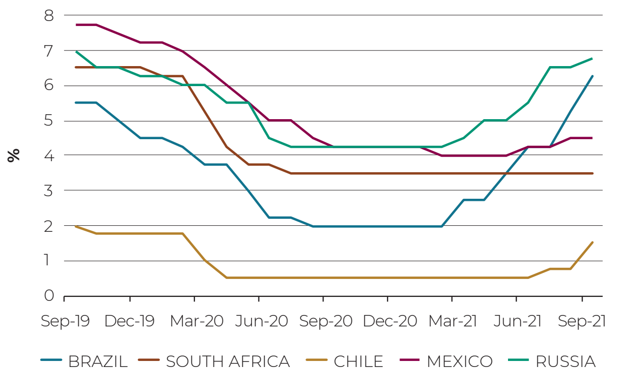
Either the Fed has done a fantastic job of signalling its intentions and avoiding surprises, or investors have taken the view that not only will a strong economy more than make up for the modest projected tightening in financial conditions, but that this modest tightening will be enough to contain inflation. The other possibility is simply that the Fed and markets are complacent, and that trouble lies in store.

STANDING OUT FROM THE CROWD

Compared to the commotion in China and the intense scrutiny of the Fed's words, last week's SARB policy meeting was very sedate. Its Monetary Policy Committee (MPC) kept the repo rate unchanged at 3.5% as expected, meaning the prime rate to which home loans are linked remains at a five-decade low of 7%.

Somewhat unusually, South Africa now stands out from other emerging markets who have been hiking rates in response to inflationary pressures. For instance, Brazil's central bank pushed its policy rate up by a full percent last week.

CHART 3: EMERGING MARKET POLICY INTEREST RATES, %



Source: Refinitiv Datastream

Emerging markets tend to have more inflation-prone economies. Exchange rates tend to be more volatile and inflation baskets have a greater weighting to food and fuel and less to services. Importantly, inflation expectations are less anchored because many countries have experienced extremely high inflation, even hyperinflation in the past generation. As recently as the 1990s, Russian inflation peaked at 160%, while Turkey hit 125%, Indonesia 82% and Mexico 51%. Chile's peak of 36% was relatively mild, but Brazil experienced hyperinflation with inflation hitting 5 000% in 1994.

While South Africa has also long been an inflation-prone economy, it is to a much lesser extent. The highest recorded inflation rate was 20% in 1986. Since the 1990s, inflation has steadily decreased, something the SARB likes taking credit for, though reintegration into the global economy probably also played a major role.

Today, inflationary pressures largely stem from the government itself in the form of administered prices. This is ironic, because the government instructed the Bank to target inflation between 3% and 6%, but tariff and rate increases from various government bodies way exceed that. In August, administered inflation was 10.3% (6.9% excluding fuel), compared to the headline consumer inflation rate of only 4.9%.

Core inflation excludes volatile food and fuel prices and electricity tariffs, and therefore shows the inflation rate of those items that are determined through the interaction of supply and demand of the local economy. Core inflation was 3.1% in August.

The SARB still believes that inflation will remain close to the midpoint of the target range. It expects inflation to average 4.4% in 2022 and 4.5% in 2023.

ASSET ALLOCATION IMPLICATIONS

Starting at home, the SARB is likely to begin a gradual hiking cycle in the next few months, even though inflation is mostly well-behaved. It is uncomfortable with negative real rates, and will be worried that not following the Fed in hiking could put downward pressure on the rand. As the impact of the pandemic fades, South Africa's growth challenges are largely on the supply side – stifling regulations, electricity shortages, infrastructure logjams and antagonistic labour relations – and the SARB does not think that lowering interest rates further will help. Therefore, the next move in rates is likely to be up.

This means that money market rates should improve somewhat, but are still likely to settle below longer-term averages. Longer-dated South African bonds are more attractive, especially given the SARB's tenacious commitment to lowering inflation (it even wants a lower target). Interest rate changes will have limited impact on the broad domestic equity market, since it mostly follows global trends as we saw again in the past week. Local equities remain cheaply priced.

As for the Fed, the message for now is steady as she goes. Global equities remain more attractive than global fixed income in a world where interest rates are historically low, even if they are set to rise somewhat. However, a negative inflation surprise would hurt both asset classes.

As for China, the picture is still very murky, and markets can still be volatile in the short term. Longer term, a prolonged downturn in the property market is likely to be negative for global growth and commodity demand, but potentially also disinflationary. This could in turn place downward pressure on global interest rates again. Once again, counterintuitively, equities could be the beneficiary. But there is still tremendous uncertainty, hence the need for investors to diversify exposure.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	3 106.0	-0.54%	-1.11%	64.86%	34.69%
United States	S&P 500	US$	4 449.0	-0.56%	-1.64%	77.46%	37.44%
Europe	MSCI Europe	US$	2 065.0	0.24%	-1.10%	38.96%	30.37%
Britain	FTSE 100	US$	9 712.0	0.21%	-0.85%	13.13%	29.37%
Germany	DAX	US$	1 737.0	-0.34%	-2.36%	-2.36%	25.42%
Japan	Nikkei 225	US$	268.7	-2.77%	6.34%	5.96%	21.24%
Emerging Markets	MSCI Emerging Markets	US$	1 273.0	-0.31%	-2.75%	31.78%	18.09%
Brazil	MSCI Brazil	US$	1 665.0	-2.12%	-9.46%	-14.35%	17.92%
China	MSCI China	US$	89.9	0.10%	-4.35%	27.73%	-7.02%
India	MSCI India	US$	869.3	0.50%	3.00%	55.80%	56.92%
South Africa	MSCI South Africa	US$	466.0	3.33%	-4.12%	4.72%	29.44%

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	64 049.0	1.16%	-5.01%	21.45%	18.07%
All Share	All Share (Total Return)	Rand	10 346.0	1.48%	-3.65%	33.84%	22.66%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	26 861.8	2.65%	-2.31%	24.39%	30.65%
TOP 40/Large Caps	Top 40	Rand	9 274.0	1.29%	-4.09%	35.80%	19.48%
Mid Caps	Mid Cap	Rand	18 717.0	3.64%	-0.06%	22.14%	45.30%
Small Companies	Small Cap	Rand	24 791.0	3.25%	4.21%	38.07%	76.64%
Resources	Resource 20	Rand	4 363.2	-2.19%	-10.84%	62.06%	14.89%
Industrials	Industrial 25	Rand	16 927.0	3.52%	-0.24%	36.34%	13.38%
Financials	Financial 15	Rand	9 212.0	2.69%	-0.48%	-1.04%	53.97%
Listed Property	SA Listed Property	Rand	1 563.9	2.52%	-0.14%	-15.05%	62.40%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	542.5	-0.38%	-0.59%	13.28%	0.37%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	806.8	-0.66%	-1.26%	27.43%	13.78%
Government Bonds	BESA GOVI	Rand	796.6	-0.66%	-1.26%	27.13%	13.72%
Inflation Linked Bonds	BESA CILI	Rand	297.2	-0.39%	0.15%	17.27%	15.22%
Cash	STEFI Composite	Rand	477.3	0.07%	0.24%	16.16%	3.80%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	77.3	2.09%	7.29%	43.06%	83.93%
Gold	Gold Spot	US$	1 768.0	-1.45%	-2.37%	38.02%	-5.86%
Platinum	Platinum Spot	US$	1 002.0	5.70%	-0.89%	26.36%	16.65%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.75	-1.03%	-1.55%	-2.72%	15.72%
ZAR/Pound	ZAR/GBP	Rand	20.24	-0.54%	-1.28%	-9.49%	7.36%
ZAR/Euro	ZAR/EUR	Rand	17.32	-0.78%	-0.95%	-4.88%	14.99%
Dollar/Euro	USD/EUR	US$	1.17	0.85%	0.94%	-1.97%	0.00%
Dollar/Pound	USD/GBP	US$	1.37	0.51%	0.58%	-6.71%	-7.44%
Dollar/Yen	USD/JPY	US$	0.01	0.53%	0.30%	0.66%	4.71%

Source: I-Net, figures as at 24 September 2021

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