ECONOMIC OVERVIEW

QUARTER 2, 2021

MENTENOVA

Contents

EXECUTIVE SUMMARY

Signs of a global economic restart continued to shine through the economic data during Q2 as vaccination programmes gained traction and global economic activity continued to pick up, with manufacturing, trade and overall sentiment showing positive trends. Diverging economic recovery paths, however, were reinforced by slower-than-expected vaccine rollouts in some countries and the emergence of new strains of the virus in various parts of the world.

Ongoing support from global fiscal and monetary authorities remained a tailwind for the global economy in Q2 as major central banks kept rates near record-low levels, while the world's largest economy approved a further round of government stimulus. These dynamics continued to support risk appetite across financial markets, with most global equity indices ending the quarter in the green. Investors meanwhile continued to find value in stocks and sectors that had been hardest hit by the pandemic, with the likes of financial stocks outperforming previous winners in the local market and listed property stocks making a strong recovery in the quarter.

The quarter was not without volatility as concerns about a sustained pick-up in inflation grew, stoking fears that interest rate hikes are on the horizon. These concerns were reinforced during June when the US Federal Reserve offered forward guidance to the market and signalled two interest rate hikes by the end of 2023.

Notwithstanding inflation-fuelled market jitters, risk assets remained broadly in favour in Q2 as the search for yield continued. The USD lost further ground during the quarter as fundamental pressures on the currency continued to build, broadly benefiting the emerging-market currency complex. The ZAR was a major beneficiary of this weakness in the USD, although positive terms of trade, attractive real yields and some strong political moves by the Ramaphosa administration offered additional support to the local unit. For local investors, the ZAR's 18% appreciation over the 1-year period to the end of Q2 will have taken some of the shine off global investment returns.

South Africa similarly showed signs of an economic recovery in Q1, with GDP data revealing that the economy expanded 4.6% year on year while the central bank raised growth forecasts for 2021, supported by global tailwinds. While this is encouraging, South Africa has visibly fallen behind in the global vaccine race and the emergence of a third wave of the virus late in Q2 suggests downward risks to the domestic economy.

As we head into the third quarter of the year, the global economy continues to benefit from aggressive vaccine rollouts and rebounding economic activity. This has translated into positive earnings outlooks and ongoing capital flows into the global equity markets.

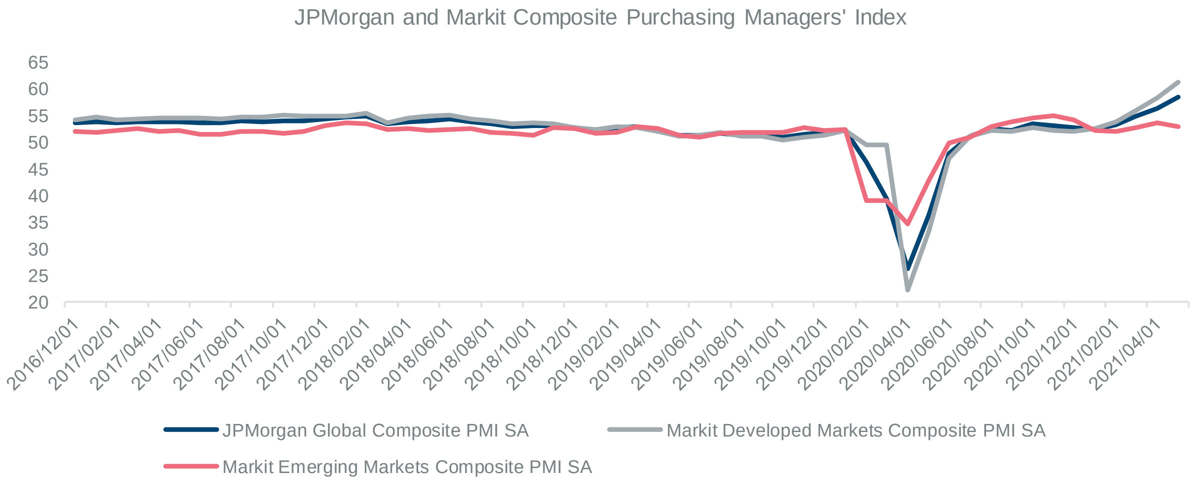
As always, there are some risks to the benign economic outlook, including uneven vaccine rollouts and new strains of the virus, as well as a sustained pick-up in inflation. Stretched valuations across several major equity indices and geopolitical tensions meanwhile also present some downside risks to the performance of financial markets in the latter half of the year. That said, the best way to achieve your investment goals is to remain invested and stick to your long-term investment strategy.

ECONOMIC AND MARKET OVERVIEW

GLOBAL ECONOMIC INDICATORS SHOW A STEADY RECOVERY

The global economy continued to show strong signs of recovery during Q2 as the vaccination rate accelerated and policymaking remained accommodative. With more than 3.2 billion shots administered by the end of June, economic activity is slowly returning to normal in many parts of the world. As we emerge from the COVID-induced global recession, manufacturing, services and trade continue to show signs of improvement, reflected in the composite PMI indicators from both the developed world and emerging markets.

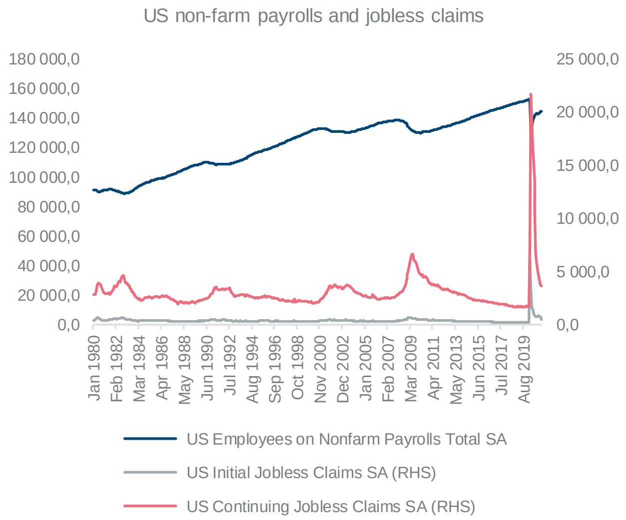
Figure 1: Global PMIs



Source: Bloomberg

The ongoing global economic recovery is also evident in improved labour market conditions in the US, where unemployment has returned to levels near the historical average of 5.8% and jobless claims continue to decline.

Figures 2 and 3: US unemployment and labour market statistics



Source: Bloomberg

While macro-economic data continues to offer encouraging signs that the economic outlook is improving, the COVID-19 pandemic continues to pose downside risks to growth as we head into the second half of the year. New strains of the virus and the staggeringly high number of vaccinations that must be administered to achieve global immunity suggest that it will still be some time before things return to normal, both on the economic and social fronts.

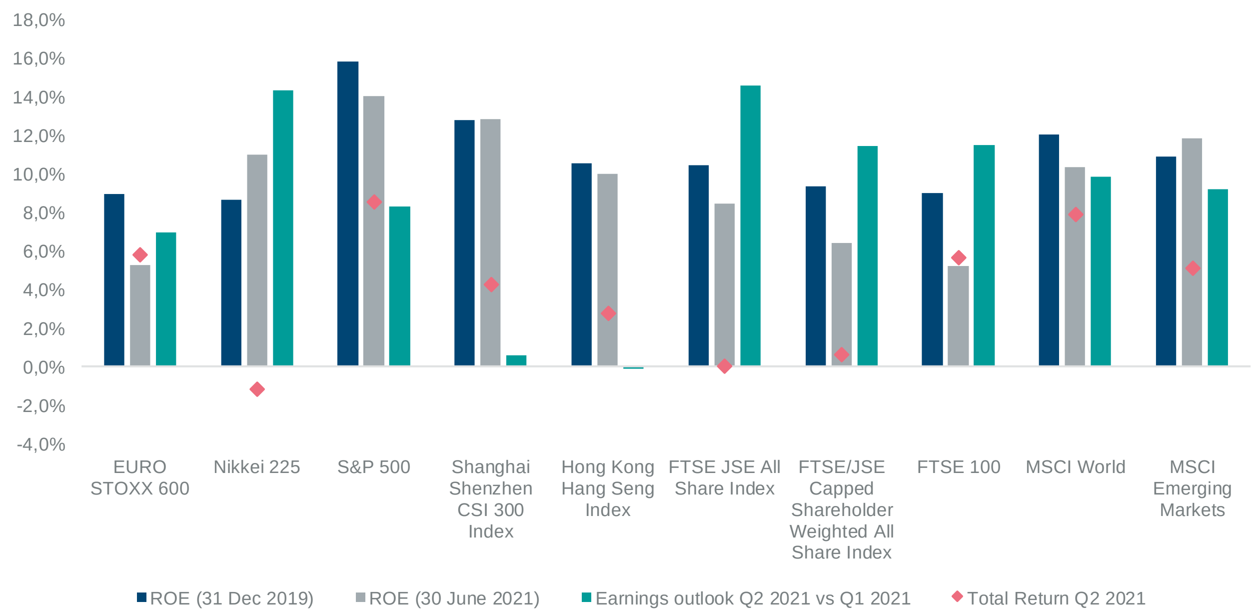
The slower vaccination rate amongst poorer nations will meanwhile continue to deepen the economic divide between the developing and developed worlds. Data compiled by Bloomberg shows that countries with the lowest incomes are visibly lagging behind the richest nations, with the vaccination rate in the wealthiest nations being 30 times that of the poorest. South Africa's path to recovery, for instance, is increasingly at risk as the third wave of the virus sweeps across the country and vaccine progress remains slow, suggesting that the country could lag both emerging and developed-market peers in terms of economic recovery over the coming quarters.

Although the possibility of further outbreaks of the virus and uneven vaccine rollouts pose some downside risks to a sustainable and synchronised global recovery, the world economy appears to be in much better shape than it was at the start of the year. This recovery has been aided by continued support from global central banks and fiscal authorities, with interest rates remaining near record low levels through Q2, and fiscal stimulus remaining firmly intact as the US government continues spending.

UPBEAT OUTLOOK SUPPORTS RISK APPETITE, CYCLICAL ROTATION

Positive corporate earnings reports, together with the ongoing search for yield, continued to drive capital flows into the global equity markets in Q2. The earnings outlook (based on earnings estimates) improved for most regions over the quarter. Return on equities for some regions into 2021 is approaching, or in some instances even surpassing, pre-pandemic levels.

Figure 3: Major equity index performance vs return on equity and earnings outlook as at 30 June 2021

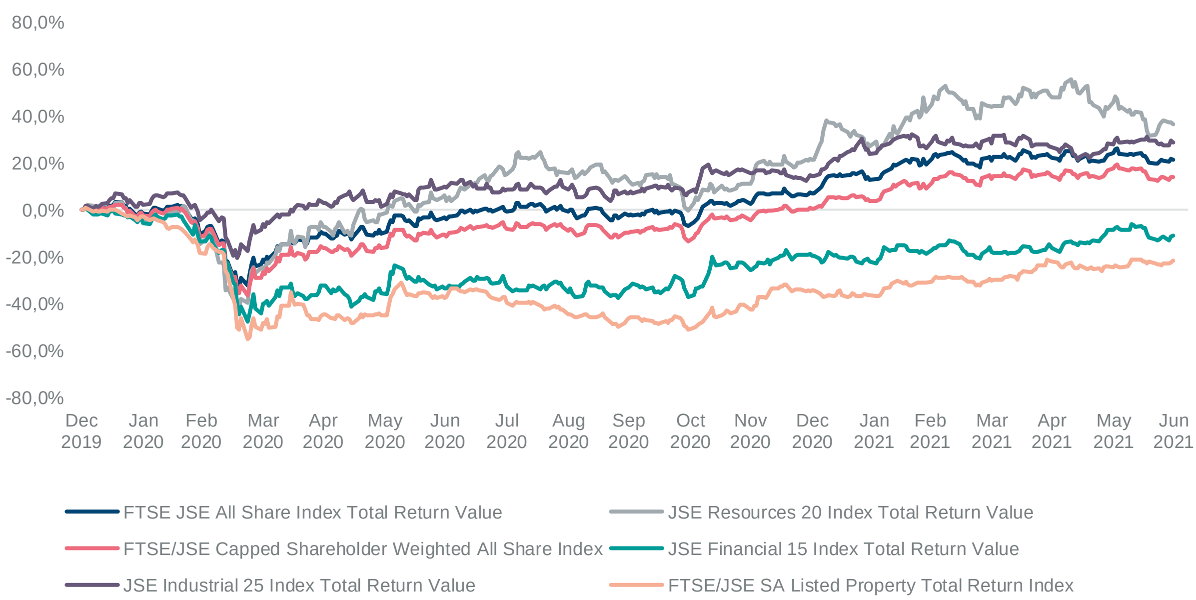


Source: Bloomberg

It is against this backdrop that most global equity markets delivered another strong quarter of performance, with the likes of the S&P 500 up by another 5% over the period. Global property indices also posted a strong performance in Q2 as optimism surrounding the reopening of economies gave the sector a boost. Commodity prices continued to soar, especially industrial metals, as manufacturing activity gained pace. Meanwhile, mining operation disruptions and surging shipping costs induced a supply squeeze.

From a style perspective, we continued to see a rotation into economically sensitive cyclical stocks and those hardest hit by the pandemic in Q2. This theme was particularly relevant for the South African markets as financials and listed property outperformed resources and industrials – in stark contrast to last year's trend.

Figure 4: SA equity index performance as at 30 June 2021

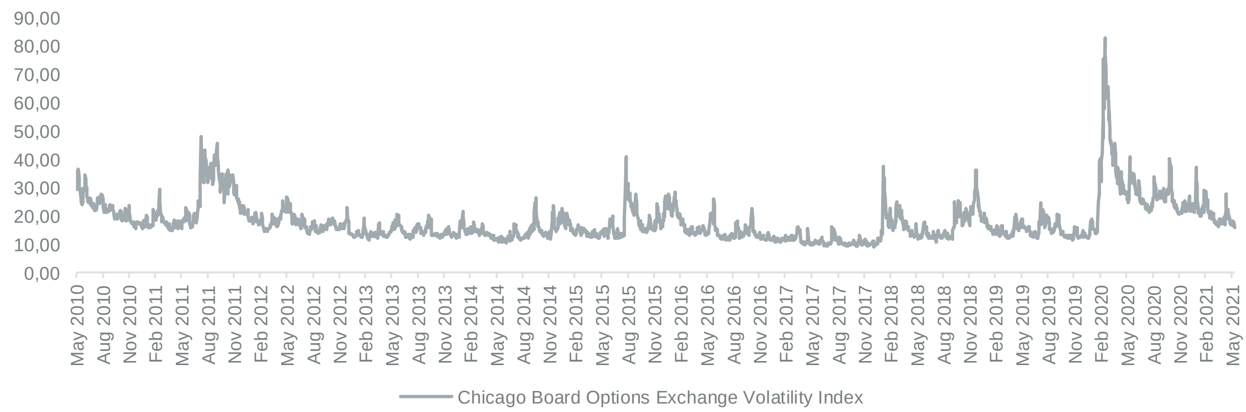


Source: Bloomberg

INFLATION FEARS GENERATE SOME MARKET ANGST

While the equity markets were broadly up in the second quarter, the markets continued to endure a fair amount of volatility, with the global fear gauge (the VIX) remaining higher than in the pre-COVID era.

Figure 4: Chicago Board Options Exchange Volatility Index (VIX) to June 2021



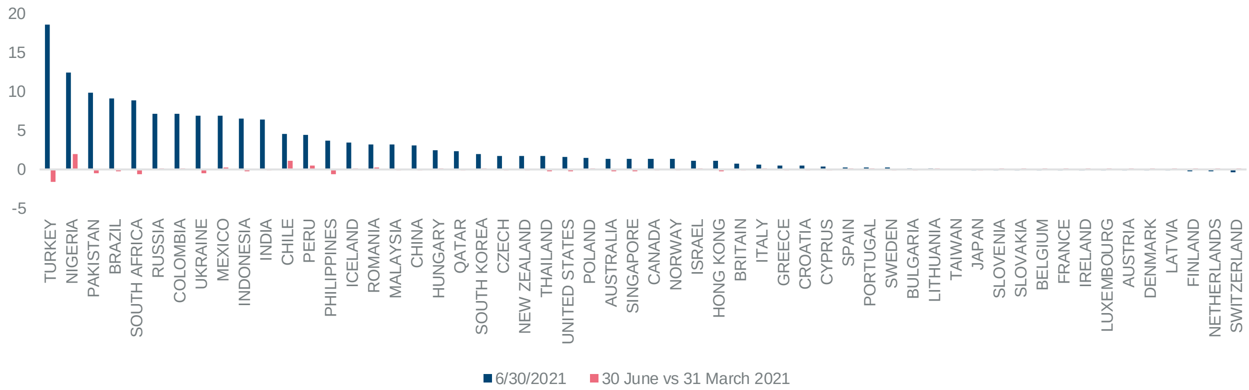
Source: Bloomberg

Much of the volatility during Q2 was linked to the uptick in global inflation, which reignited concerns that interest rate hikes and the tapering of easy monetary policy are on the horizon. While the recent spike in inflation has mainly been driven by one-time reopening effects and base effects, improving demand as well as ongoing supply-chain bottlenecks and rising input costs continue to pose upside risks to inflation in the near term.

It is against this backdrop that major central banks are signalling that the COVID-induced, unconventional and accommodative monetary conditions are unlikely to continue forever. In fact, this is the exact message that came out of the US Federal Reserve's meeting in June. Specifically, the central bank revised its 'dot plot', indicating that interest rate hikes may be introduced sooner than previously anticipated. Eleven out of 18 US Fed officials now expect at least two rate hikes in 2023, with seven officials anticipating interest rate increases by the end of 2022. In addition, the Fed has made upward revisions to several US economic projections, including GDP growth and PCE inflation (the Fed's preferred measure of inflation).

Global bond yields increased across most developed markets owing to a pick-up in short-term inflation and interest rate expectations, causing yield curves to flatten in Q2. The picture for developing market bonds, however, was more mixed, with diverging economic recovery paths and the search for yield playing a part.

Figure 5: 10-year government bond yields as at 30 June 2021



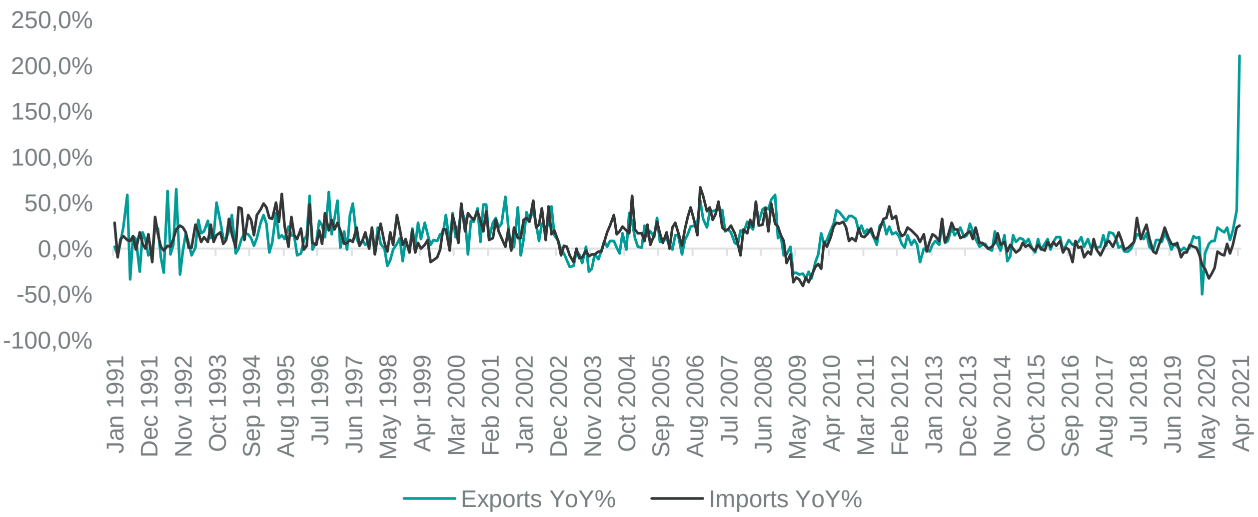
Source: Bloomberg

USD WEAKNESS, IDIOSYNCRATIC FACTORS LEND SUPPORT TO ZAR

Emerging-market currencies continued to benefit from a weaker USD in Q2, with the USD coming under significant pressure as US trade and current account deficits widen and the Fed's monetary policy stance remains accommodative. The continued improvement in risk appetite also continued to drive flows out of safe-haven currencies into higher-yield currencies, reversing the USD support seen last year during the height of the pandemic. The ZAR was a major beneficiary of the USD weakness as it appreciated by another 3.3%, translating into an 18% appreciation over the year that ended 30 June 2021.

While the weaker USD has had a major part to play in the ZAR's performance over the past year, some idiosyncratic factors have contributed to its strong performance relative to other emerging-market currencies. These factors include a trade surplus and positive current account balance in the wake of a rebound in exports amid improving global economic conditions and rising commodity prices. Export growth has outstripped import growth as weak domestic demand continues to constrain imports. The net effect has been a reduced need for external funding and support for the domestic currency.

Figure 6: SA exports and imports to end April 2021



Source: Bloomberg

South Africa also boasts some of the most attractive real yields on a relative basis, thus continuing to support demand for domestic assets, including the ZAR. This can be seen when comparing SA's real yields to those of some of its major emerging-market peers.

Figure 7: SA bond yields vs EM peers as at 14 June 2021

	South Africa	India	Indonesia	Russia	Mexico	Brazil	Turkey
10 Year Yield	**8.99%**	**6.01%**	**6.35%**	**7.09%**	**6.66%**	**9.28%**	**18.09%**
Inflation	4.4%	4.3%	1.68%	3.3%	5.9%	8.1%	16.6%
Inflation Expectation	4.10%	6.20%	2.20%	5.10%	4.06%	5.10%	15.00%
10 Year Real Yield	**4.59%**	**1.72%**	**4.67%**	**3.79%**	**0.77%**	**1.22%**	**1.50%**
10 Year Real Yield based on inflation expectation	4.89%	-0.19%	4.15%	1.99%	2.60%	4.18%	3.09%
Currency Risk Premium	**4.89%**	**3.12%**	**3.52%**	**4.17%**	**3.60%**	**5.32%**	**12.57%**
Sovereign Risk Premium	**2.65%**	**1.44%**	**1.38%**	**1.46%**	**1.61%**	**2.50%**	**4.07%**
US 10 Year Yield	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
S&P Rating - Foreign Currency	**BB-**	**BBB-**	**BBB**	**BBB-**	**BBB**	**BB-**	**B+**
Moody's Rating - Foreign Currency	**Ba2**	**Baa3**	**Baa2**	**Baa3**	**Baa1**	**Ba2**	**B2**

Source: Bloomberg

Note that S&P Global and Fitch Ratings affirmed South Africa's long-term sovereign credit ratings during the second quarter. While S&P maintained its stable outlook, the agency warned that the slow pace of vaccinations was a potential new medium-term constraint to growth recovery. Fitch meanwhile maintained its negative outlook for South Africa and continued to warn of the substantial risks to debt stabilisation. The rating agency did, however, commend the substantial progress that has been made in respect of independent power producers, which is seen as an important step towards easing power-supply constraints over the medium to long term.

Developments on the political front during the second quarter have offered renewed hope that reform is under way, with Ramaphosa making some strong political moves in recent months, including adopting a tougher stance on corruption in the public sector.

LOOKING AHEAD

As we head into the second half of 2021, conditions remain broadly favourable for emerging markets and other risky assets: the world economy continues to recover from the lockdown-induced recession of 2020 and global liquidity conditions remain accommodative, supporting the continued search for yield. However, it is worth highlighting some of the risks to the markets in the coming months.

Virus-related risks

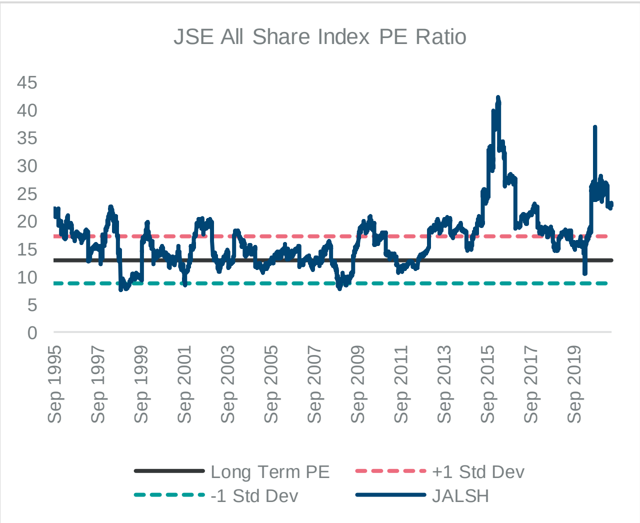
The world continues to make encouraging strides in inoculating populations. However, the data suggests that if we continue at the current pace of vaccinations, we are still another year away from achieving a high level of global immunity. Risks related to uneven vaccine rollout and further strains and mutations of the virus continue to feature prominently as 2021 unfolds. A lot of good news related to the economic recovery has been priced into the markets and any major setbacks in returning to normal could hurt sentiment.

Stretched valuations

Several major global equity markets score as expensive on several standard valuation measures and metrics, even though it should be pointed out that this is in a very low interest-rate environment. The P/E ratio of the S&P 500 index, for instance, continues to hover above 30, compared to its long-term average of around 17.

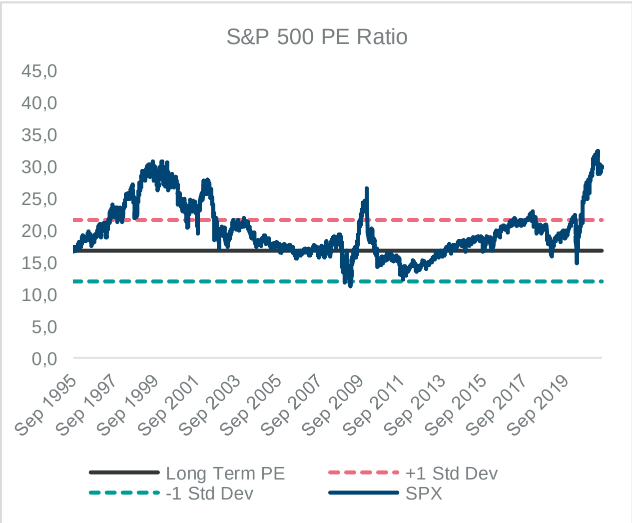
This suggests that the prospects for a continuation of double-digit returns from the broader equity markets have diminished. While pockets of opportunity remain, with some markets looking more expensive than others, it does imply that returns from the broader equity market may be more muted going forward. This is the type of environment where good, active stock selection is typically rewarded.

Figure 6: JSE ALSI Historical Price-to-Earnings Ratio



Source: Bloomberg

Figure 7: S&P 500 Historical Price-to-Earnings Ratio



Source: Bloomberg

Rising inflation and tapering of accommodative monetary policy

As the global economy recovers, a sustained uptick in inflation remains a risk that could force central banks to tighten liquidity. With accommodative monetary policy driving investors into risky assets, it stands to reason that the tightening of monetary policy poses some downside risks to the strong flows into global equity markets.

While the threat of inflation is expected to continue generating some market angst and stoke volatility, history suggests that there are segments of the global equity market that stand to benefit from an inflationary environment, such as gold and cyclical stocks.

Ongoing geopolitical tensions

As we head into the second half of 2021, geopolitical tensions continue to feature prominently and heighten risk. In this regard, negative views on China are mounting across the Western world. Not only do US–China trade relations remain strained, but EU–China ties have also frayed this year in the wake of the US and Europe continuing to press China on democratic and human rights issues. What is particularly topical, as we head into Q3, is the recent probe into tech company Didi Global by the Chinese regulator, shortly after its listing in the US, which was triggered by concerns over big data and cybersecurity. Further actions like this could curb investors' appetite for Chinese tech giants and also potentially constrain China's access to deep, offshore capital markets.

APPENDIX

Figure 8: Financial market performance as at 30 June 2021

Index	1 Month	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Local Equity Indices							
FTSE/JSE All-Share Index (ALSI)	-2,4%	0,0%	25,1%	8,1%	8,1%	7,0%	10,9%
FTSE/JSE Resources 20 Index	-6,5%	-5,1%	28,4%	19,3%	20,3%	5,4%	5,3%
FTSE/JSE Industrials Index	0,4%	0,8%	19,4%	6,2%	5,5%	7,0%	13,5%
FTSE/JSE Financials Index	-2,1%	7,9%	31,8%	-3,0%	0,7%	2,8%	9,2%
FTSE/JSE Shareholder Weighted Index (SWIX)	-2,8%	-1,8%	21,8%	5,0%	5,3%	5,8%	10,4%
FTSE/JSE Capped Swix Index (Capped SWIX)	-3,0%	0,6%	27,6%	4,8%	4,3%	5,0%	
FTSE/JSE All-Share Top 40 Index	-2,6%	-0,8%	23,0%	8,5%	8,7%	7,0%	11,0%
FTSE/JSE SWIX Top 40 Index	-3,0%	-3,5%	18,3%	4,7%	5,3%	5,6%	
FTSE/JSE Mid Cap Index	-2,6%	5,9%	33,4%	5,0%	3,1%	5,4%	9,2%
FTSE/JSE Small Cap Index	-1,0%	8,0%	65,2%	4,3%	3,2%	4,8%	10,1%
FTSE/JSE Listed Property Index (SAPY)	3,4%	12,1%	25,2%	-8,9%	-6,9%	-0,2%	5,1%
FTSE/JSE Capped Listed Property Index	3,0%	10,5%	24,2%	-12,9%	-10,1%	-3,3%	
Local Interest-Bearing Indices							
FTSE/JSE All-Bond Index (ALBI)	1,1%	6,9%	13,7%	9,2%	9,2%	8,5%	8,5%
FTSE/JSE All-Bond Index 1 - 3 years	0,0%	1,4%	4,9%	8,8%	8,5%	8,1%	7,7%
FTSE/JSE All-Bond Index 3 - 7 years	0,1%	2,0%	8,9%	10,8%	10,1%	9,4%	9,0%
FTSE/JSE All-Bond Index 7 - 12 years	1,0%	6,6%	13,0%	10,4%	9,8%	9,0%	9,0%
FTSE/JSE All-Bond Index +12 years	1,7%	10,1%	17,9%	8,4%	8,7%	8,1%	8,4%
Inflation Linked Government Bonds (IGOV)	-1,6%	3,0%	14,8%	4,9%	3,2%	4,2%	
Short-Term Fixed Interest Composite Index (SteFi)	0,3%	0,9%	4,0%	6,1%	6,6%	6,6%	6,3%
Inflation Index							
Consumer Price Index (1 month lagged)	0,1%	1,4%	5,2%	3,9%	4,3%	4,6%	5,0%
International Indices							
MSCI World Index	5,7%	4,6%	15,1%	17,1%	14,9%	15,6%	19,9%
MSCI Emerging Market Index	4,4%	2,0%	16,5%	13,2%	12,8%	11,4%	12,8%
FTSE World Government Bond Index (WGBI)	3,1%	-2,1%	-17,0%	5,0%	1,1%	5,8%	9,3%
S&P Global Property	5,0%	4,8%	8,6%	8,3%	5,7%	10,6%	15,6%
USA S&P 500	6,5%	5,3%	16,0%	20,3%	17,0%	19,1%	23,8%
UK FTSE 100	1,6%	2,5%	8,4%	4,0%	5,9%	5,8%	12,1%
Euro STOXX 50	1,6%	2,6%	11,3%	10,6%	10,7%	8,3%	12,5%
Japan Nikkei 225	2,6%	-4,6%	5,0%	12,4%	13,0%	15,0%	18,5%
Currency Movement							
Rand/Dollar (R13.74= 1 Dollar)	4,0%	-3,3%	-17,7%	1,3%	-0,6%	4,3%	7,8%
Rand/Euro (R16.8= 1 Euro)	0,9%	-2,3%	-13,1%	1,8%	0,7%	2,2%	5,6%
JPY/Rand (7.97Japanese Yen= 1 South African Rand)	-2,4%	3,9%	25,1%	-1,2%	2,1%	-2,8%	-4,2%
Rand/Pound (R19.53= 1 Pound)	1,2%	-3,0%	-8,2%	2,9%	0,1%	1,2%	6,2%

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