ECONOMIC OVERVIEW

QUARTER 2, 2022

MENTENOVA

Contents

EXECUTIVE SUMMARY

A series of shocks left financial markets reeling in the first half of the year, with nowhere for investors to hide as both stocks and bonds declined sharply. From high inflation and monetary tightening to the war in Ukraine and lockdowns in China, it has certainly been a challenging environment to navigate. With many stock markets entering bear market territory and bond yields rising, the majority of investor portfolios have suffered.

For the first six months of the year, the MSCI World Index was down by close to 19% in ZAR terms, while the World Government Bond Index was down by 13% following a sharp rise in bond yields. US stocks meanwhile had their worst first half since the 1970s, with growth stocks leading the decline. South African equities and bonds were not left unscathed as they ended the first half down by 8% and 2%, respectively, although strong commodity prices softened the blow for commodity exporters in the first six months.

Uncertainty surrounding the outlook for the global economy and the path of interest rates, amid the ongoing war in Ukraine and rising inflation, were key drivers of financial markets during the first half of the year. Firmer demand, ongoing supply disruptions and high energy prices have pushed prices above central bank target levels across the globe, and central banks have been forced to act.

With interest rates rising, inflation remaining high and the war continuing, global economic growth is expected to slow down quicker than previously expected, with the World Bank's June forecasts predicting a decline from 5.7% in 2021 to 2.9% this year. While regional outlooks differ, the impact of the war is expected to be most severe for Europe and Asia.

For South Africa, stronger commodity prices have offset some of the negative impacts of a substantial increase in energy prices, in the form of positive terms of trade and an improved fiscal position. However, some of these benefits have started to fade as commodity prices have lost some momentum, and the country remains vulnerable to a broader global slowdown. In addition, a sharp increase in the number loadshedding hours that people are having to endure remains a key downside risk to the local economy.

Heading into the second half of the year, risks to the global economy remain skewed to the downside as the war in Ukraine shows no signs of letting up and elevated levels of inflation keeps pressure on households and consumption. Additionally, China's zero COVID policy continues to dampen the outlook and is keeping pressure on global supply chains.

While the global economy is set to weaken sharply, elevated levels of inflation will continue to see central banks withdrawing the post-pandemic policy support that was responsible for two years of strong returns across risk assets. Against this backdrop, investor sentiment remains sensitive to the actions of global central banks and how they plan to balance the threat of inflation against slowing global growth. With the outlook clouded by much uncertainty, though, we could be in store for more financial market volatility in the months ahead.

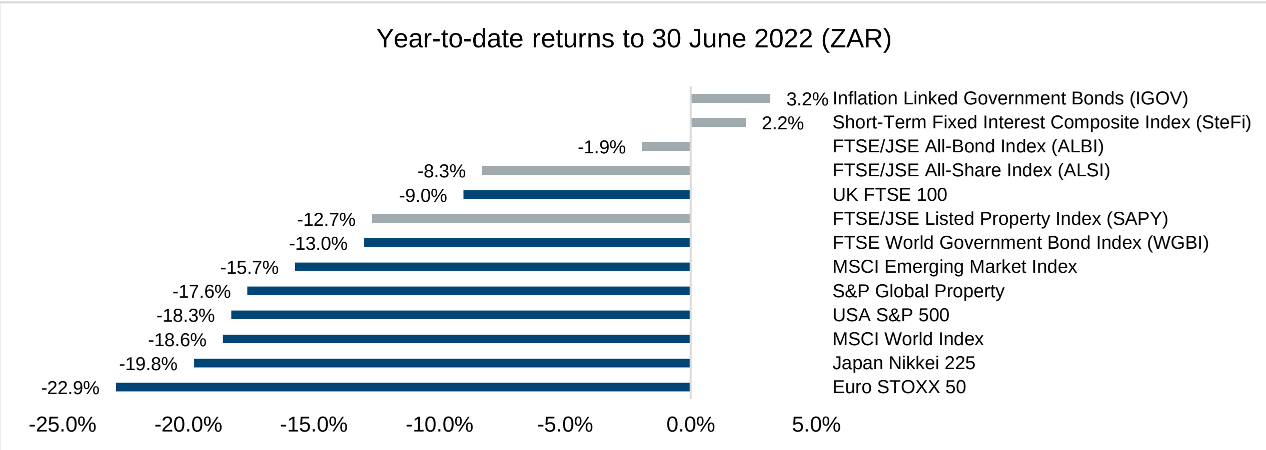
On a more positive note, the sharp pullback in financial markets has presented a welcome opportunity for many long-term investors to enter the markets at more attractive valuations. Looking past short-term volatility and remaining focused on your long-term objectives remains our best advice for achieving your goals over the long-term.

ECONOMIC AND MARKET OVERVIEW

NOWHERE TO HIDE AS STOCKS AND BONDS TUMBLE

There was no reprieve for investors in the second quarter as uncertainty surrounding the outlook for the global economy and interest rates mounted. As both global stocks and bonds continued to tumble, there was nowhere to hide. As a result, most asset classes finished the first half of the year deep in negative territory, with the exception of local inflation-linked bonds and local cash. The chart below shows the performance of selected local and offshore indices for H1 2022 in ZAR terms.

Chart 1: Year-to-date performance of local and international indices in Rands

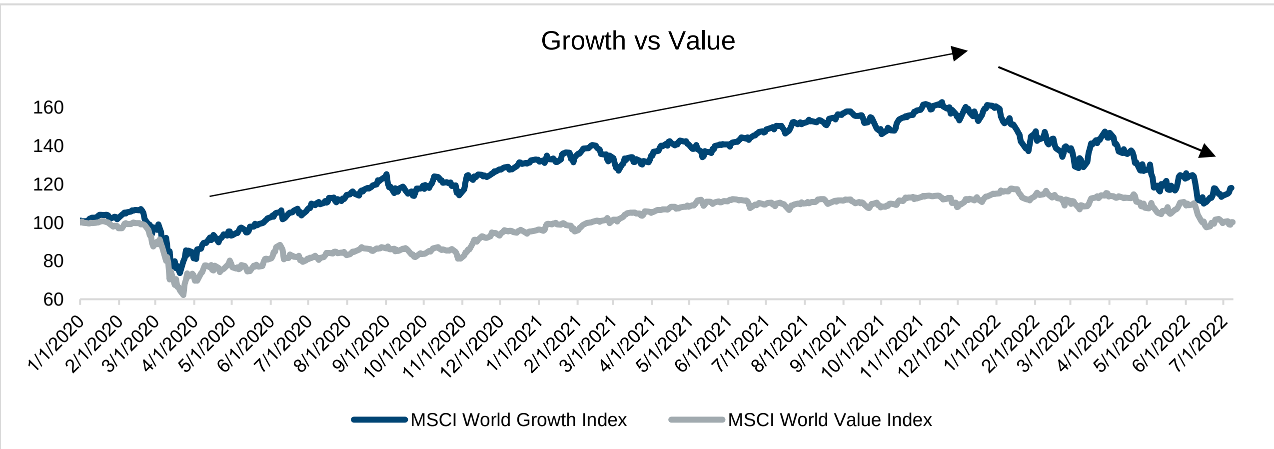


Source: Bloomberg

Emerging market equities, as measured by the MSCI World EM Index, declined by close to 16% for the first half, slightly outperforming developed market equities which dropped by a hefty 19%. Notably, the S&P 500 had its worst first half since the 1970s, dropping by over 20% in USD terms and moving into bear market territory.

Growth stocks such as big tech counters were amongst the hardest hit in H1 2022 as higher interest rate expectations reduced the present value of future profits, impacting those stocks with the highest valuations. Cheaper value stocks outperformed their growth counterparts as the markets rotated away from growth and into value, closing the gap that has prevailed since the onset of the pandemic.

Chart 2: Cumulative performance of MSCI World Growth Index vs MSCI World Value index to end June 2022

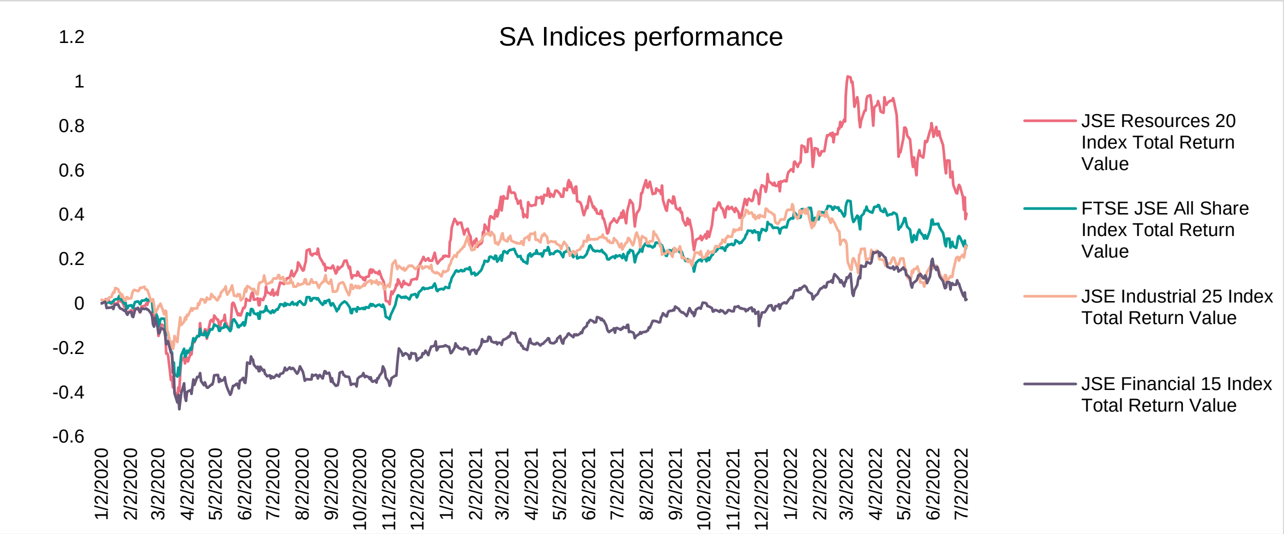


Source: Bloomberg

On the domestic front, South African equities were amongst the better-performing equity markets in the first half of the year as strong commodity prices benefited net commodity exporters. However, the JSE All Share Index still lost just over 8% during H1 2022, with most of these losses recorded in the second quarter as resources and financials reversed the gains recorded earlier in the year.

More specifically, resources ended Q2 down by more than 20% as industrial metals declined sharply on the back of recession fears, wiping out gains recorded in Q1. Financials also failed to maintain their strong run, declining by 16% in Q2 and offsetting positive returns recorded earlier in the year. Industrials meanwhile outperformed at a super-sector level in Q2, benefiting from a share buy-back announcement from Naspers and Prosus The chart below shows the cumulative performance of SA equity indices up to the end of June 2022.

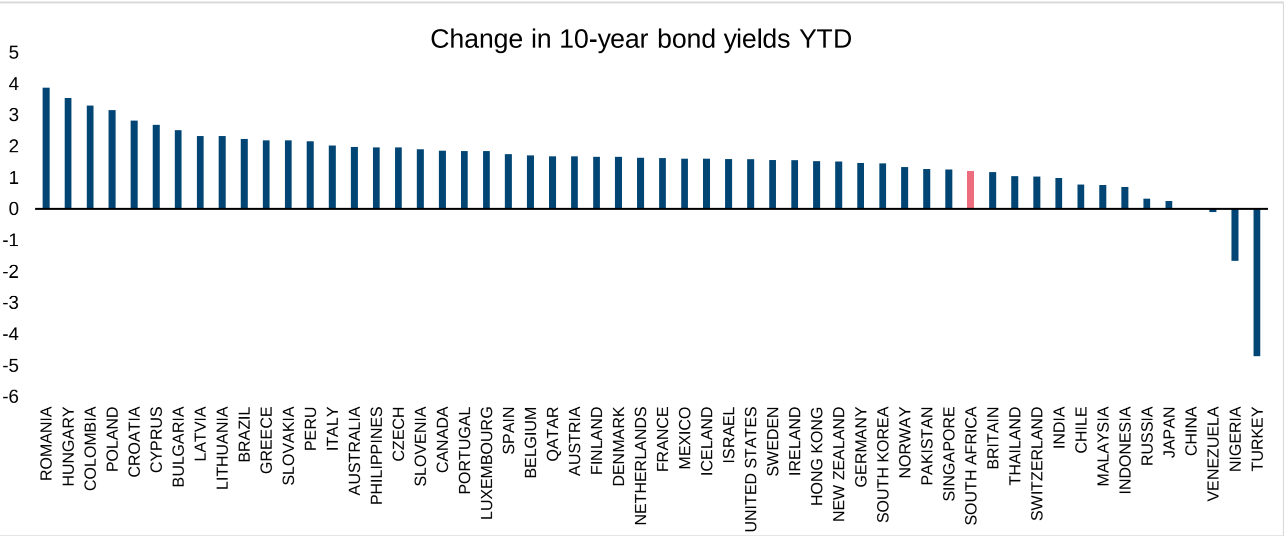
Chart 3: Cumulative performance of SA indices since 2020 up to 30 June 2022



Source: Bloomberg

Global bonds were meanwhile firmly on the back foot in H1 2022 as inflation climbed and central banks across the globe responded by tightening policy, exerting upward pressure on bond yields. South African bond yields ticked up alongside global bonds, with the 10-year yield returning to above 10%.

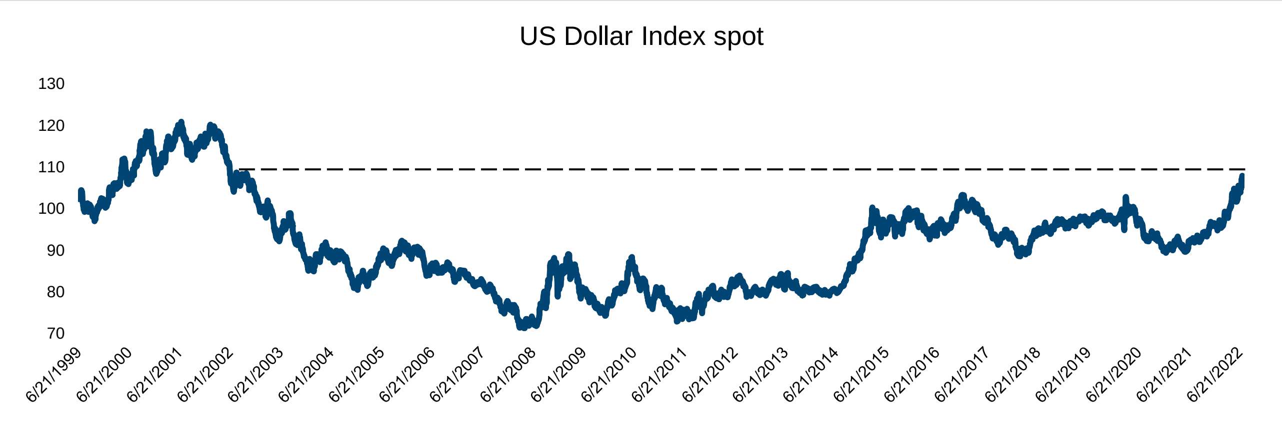
Chart 4: Year-to-date change in 10-year nominal global bond yields



Source: Bloomberg

For local investors, the Rand's depreciation of over 11% for Q2 offset some of the ZAR-denominated losses recorded across global bond and equity markets, with a strong USD keeping most emerging market currencies under pressure during the quarter. Expectations for aggressive interest rate hikes from the US central bank and the safe-haven appeal of the currency during times of market volatility have kept the USD underpinned so far this year, with the US Dollar Index at its strongest level since the early 2000s.

Chart 5: Spot prices of US Dollar Index (DXY) to 30 June 2022

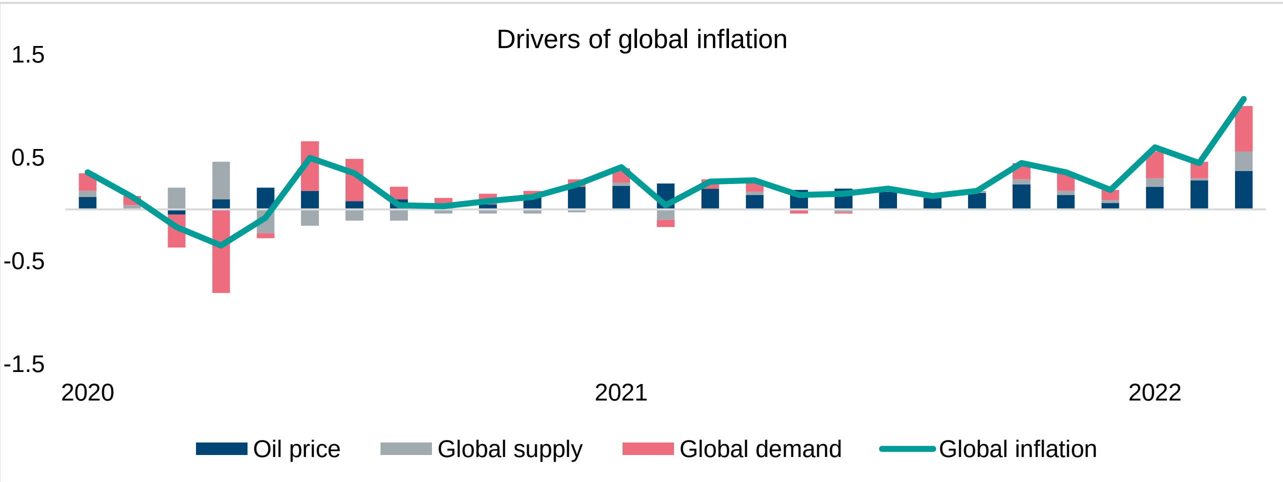


Source: Bloomberg

RED HOT INFLATION KEEPS PRESSURE ON CENTRAL BANKS

High levels of inflation were already a concern at the start of the year as pent-up demand from the pandemic and supply chain disruptions continued to play out. However, the Russian invasion of Ukraine and renewed lockdowns in China have exacerbated these pressures and pushed inflation to its highest level in decades in many parts of the world. The chart below shows the drivers of global inflation since 2020, highlighting the three major contributors to inflation: firmer demand, supply-side constraints, and high oil prices.

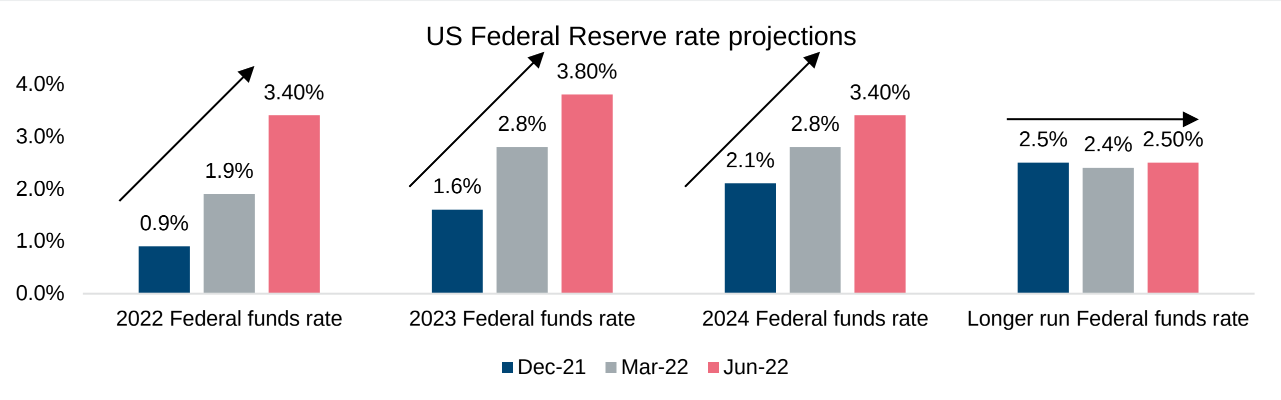
Chart 6: Keys drivers of global inflation since 2020



Sources: Ha, Kose, and Ohnsorge (2021a); World Bank.

With inflation running above target in most developed countries and emerging markets that have adopted inflation targeting, central banks have been forced to respond and hike rates faster than previously anticipated. The US Federal Reserve hiked rates by another 75bps during June to 1.75%. Moreover, the central bank suggests that there are more big hikes to come as it faces a strong US labour market and inflation well above its long-term target. The chart below shows the US Federal Reserve's upward revisions to the interest rate forecast since the end of last year, implying hikes of between 1.50% and 1.75% during the remainder of 2022 and a further ~50bps in 2023 before reverting to cuts in 2024.

Chart 7: US Federal Reserve median projections for the US Fed Funds rate



Source: Federal Reserve: Summary of Economic Projections

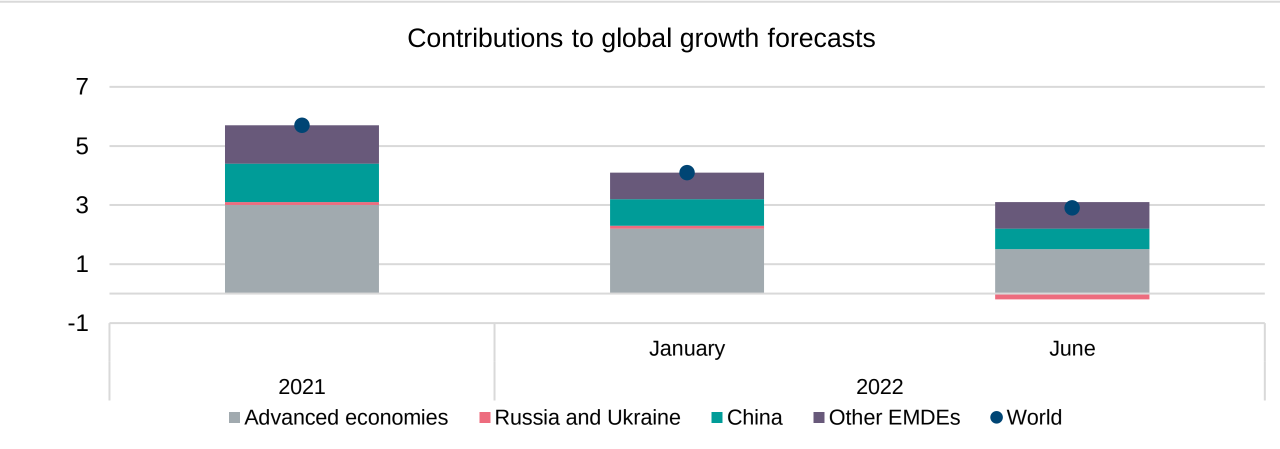
The acceleration in monetary policy normalisation has prompted the South African Reserve Bank to also step up the pace of interest rate hikes, with the central bank having hiked rates at each of its monetary policy committee meetings so far this year. According to the SARB's latest quarterly projection model, more 50–75bps hikes are expected during the remainder of the year, followed by further normalisation in 2023 and 2024.

GLOBAL RECESSION FEARS MOUNT

As policy accommodation continues to be unwound, financial conditions are tightening and global growth is slowing. The energy shock resulting from the ongoing war in Ukraine has accelerated this slowdown, further constraining policy space and weighing on global economic activity.

According to the World Bank's latest economic projections from June, global growth is expected to slow to 2.9% this year from 5.7% last year, reflecting the impact of a continuation of war-related uncertainty, fading policy support and slower demand. This is a downward revision of 1.2% compared to the World Bank's forecasts at the start of 2022. The chart below shows a breakdown of the latest projections for global growth compared to those at the start of the year and in 2021.

Chart 8: Breakdown of World Bank's global growth forecasts in 2021, January 2022 and June 2022



Source: World Bank

While global growth is projected to slow sharply, the impact of the ongoing war in Ukraine and the pace of policy tightening differ across regions. The Euro area is expected to be the hardest hit by the war due to its reliance on Russian oil and gas and remains vulnerable to spillovers from the war. A recent poll conducted by Bloomberg shows that economists are forecasting a 45% chance of a recession in the Euro area in the next 12 months. While the European Central Bank has indicated that rate hikes are on the cards, it has yet to hike rates as we head into the second half of the year.

Following a strong recovery from the pandemic, the US economy is also expected to slow as pent-up demand fades and policy support is withdrawn. However, there is growing concern that the pace and magnitude of the Fed's tightening could accelerate the slowdown and tip the economy into a recession. Meanwhile, economic activity in China has been significantly constrained by recent COVID-19 outbreaks and the country's zero-COVID policy, which has curtailed consumption and kept pressure on the country's real estate sector, with Chinese policymakers having responded with policy easing.

COMMODITY PRICES OFFER SOME REPRIEVE FOR SOUTH AFRICA IN 2022

South Africa's growth forecasts have also been revised downwards in conjunction with global growth forecasts, with the SARB's latest forecasts showing that the economy is projected to grow by 1.7% this year, down from a 2% projection at its March meeting. While South Africa remains vulnerable to a slowdown in global growth, the commodity price rebound has been beneficial for net commodity-exporting countries such as South Africa.

Stronger commodity prices have offset some of the negative impacts on the domestic economy of a substantial increase in the oil price, in the form of positive terms of trade, a more stable exchange rate and ultimately an improved fiscal position. The improvement in South Africa's fiscal position resulted in credit rating agencies upgrading the country's credit rating outlook during the first half of the year. S&P recently upgraded SA's credit rating from stable to positive, while Moody's upgraded the outlook from negative to stable.

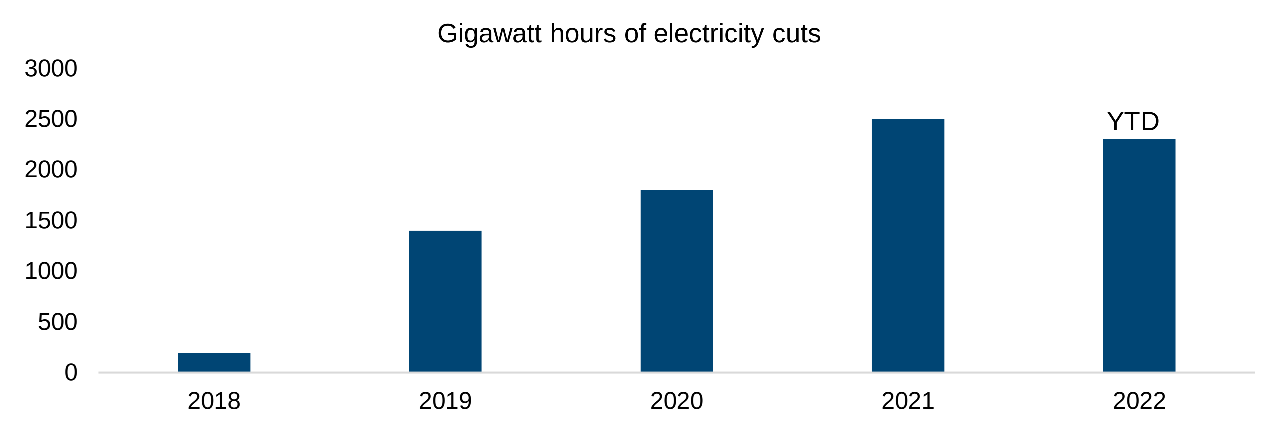
Chart 9: Current South Africa credit ratings according to main rating agencies

Rating Agency	Rating	Grade	Outlook	Last Update	Action
S&P	BB-	Non-investment grade	Positive	May 2022	Outlook upgraded
Moody's	Ba2	Non-investment grade	Stable	April 2022	Outlook upgraded
Fitch	BB-	Non-investment grade	Stable	Dec 2021	Outlook upgraded

Source: Bloomberg

While this is encouraging, structural factors continue to present downside risks to the local economy, most notably electricity supply constraints. The chart below shows the gigawatt hours of electricity cuts since 2018, with hours of loadshedding for the first six months of this year nearing last year's record of over 2,500 gigawatts, as Eskom attempts to avoid a collapse of the entire grid.

Chart 10: Annual gigawatt hours of loadshedding since 2018



Source: Council for Scientific and Industrial Research

LOOKING AHEAD

Heading into the second half of the year, risks to the global economy remain skewed to the downside as the war in Ukraine continues and elevated levels of inflation persist, forcing central banks across the globe to withdraw their post-pandemic policy support that was responsible for two years of strong returns across risk assets. Against this backdrop, investors are likely to remain focused on the actions of global central banks and how they plan to balance the threat of inflation against slowing global growth. With the outlook clouded by much uncertainty, though, we could be in store for more financial market volatility in the months ahead.

Risk of stagflation remains a concern

With growth slowing at a rapid rate and inflation remaining at elevated levels, the risk of stagflation, i.e., a protracted period of low growth and high inflation, remains a concern. The last time the global economy faced a situation like this was in the 1970s when supply shocks and accommodative policy resulted in a period of stagflation. This ultimately required steep increases in interest rates, which triggered a global recession.

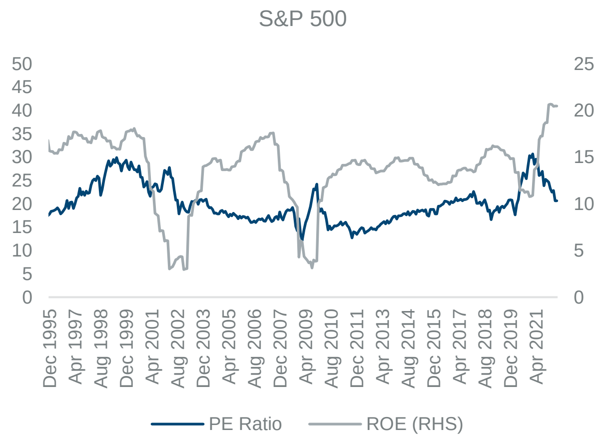
While there are parallels between the experience of the 1970s and the current economic context, there are also some differences. Aside from structural changes to the economy since the 1970s, current monetary policy frameworks are keeping inflation expectations anchored as central banks continue to signal their commitment to containing inflationary pressures. This should help prevent major policy surprises and a destabilisation of financial markets.

Still, with inflation rising and growth moving in the opposite direction, policymakers do not have the same levers available to prop up the financial markets that they had during the COVID-19 pandemic, and the markets are wary of the possible outcomes.

More attractive valuations offer opportunity

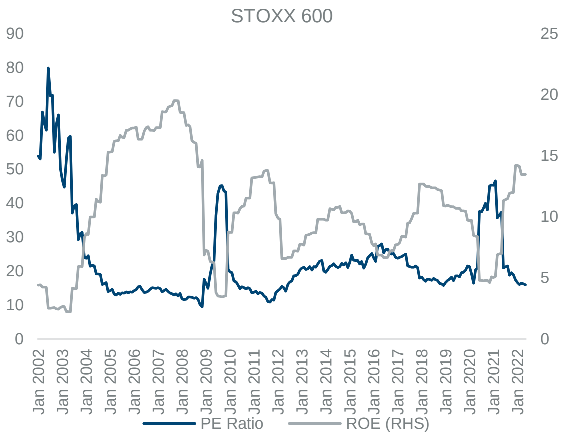
As central banks have moved away from policy easing towards tightening, markets have adjusted and valuations have shifted downwards to reflect the rise in yields. While this has caused some pain for investors since the start of the year, it also presents an opportunity for investors to find new opportunities at more reasonable valuations compared to those seen at the end of last year. The charts below show the historical price-to-earnings ratio and return on equity for the S&P 500 and the STOXX 600.

Chart 11: S&P 500 PE Ratio and ROE



Source: Bloomberg

Chart 12: STOXX 600 PE Ratio and ROE



Source: Bloomberg

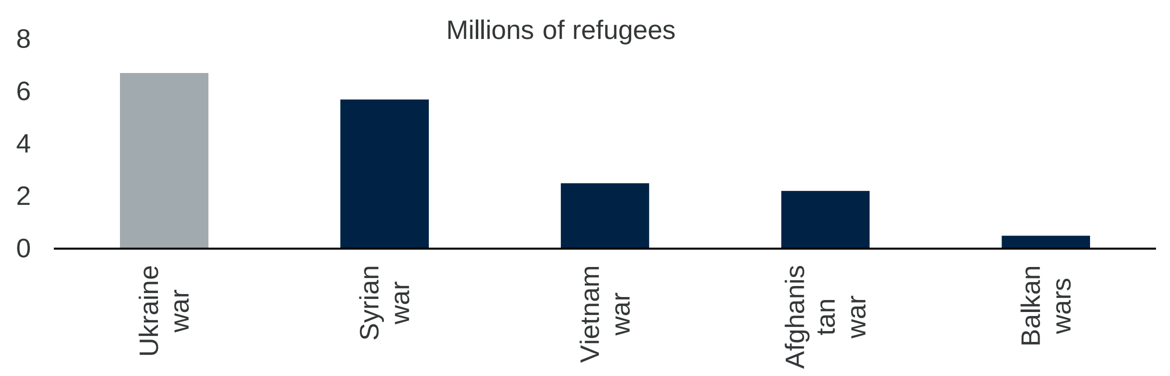
Cost of servicing debt is rising

Tighter global financial conditions and rising borrowing costs have made the servicing of debt more expensive, which grew significantly during the pandemic as governments stepped in to shore up their economies. While fiscal policy accommodation is slowly being unwound, the increase in borrowing costs poses risks to countries with heavy debt burdens. Fiscal discipline and renewed efforts to put debt on a more manageable path will be required by policymakers across the globe.

Geopolitical risks remain front and centre

As the war in Ukraine rages on, there is a growing risk of more geopolitical uncertainty. The impact of the war has already seen millions of people flee to other countries as refugees – a situation that could worsen in the short term as the war continues, adding to affected countries' fiscal burdens and risking famine and social unrest. The chart below shows the number of registered refugees fleeing similar wars but highlighting that the war in Ukraine is unprecedented, having triggered one of the biggest refugee crises in history.

Chart 13: Number of registered refugees escaping various wars



Sources: Barutciski (1994); United Nations High Commissioner for Refugees; World Bank.

In addition, global trade and networks could be further impacted if the conflict worsens, and sanctions could intensify. The war in Ukraine has increased the risk of more protectionist policies and less global co-operation, which could have significant consequences for geopolitics and the global economy in the longer run. Finally, geopolitical tensions have accelerated the drive for a transition to clean energy.

APPENDIX

Financial market performance at 30 June 2022 (ZAR)

Index	1 mth	3 mths	YTD	1 yr	3 yr (p.a.)	5 yr (p.a.)	7 yr (p.a.)	10 yr (p.a.)
Local Equity Indices								
FTSE/JSE All-Share Index (ALSI)	-8.0%	-11.7%	-8.3%	4.7%	8.2%	8.7%	7.0%	10.5%
FTSE/JSE Resources 20 Index	-17.2%	-21.9%	-7.7%	8.5%	15.9%	21.7%	11.9%	7.3%
FTSE/JSE Industrials Index	0.9%	-3.0%	-15.7%	-6.3%	5.2%	3.8%	4.0%	10.7%
FTSE/JSE Financials Index	-12.9%	-15.3%	-1.1%	14.5%	-0.4%	2.9%	2.0%	8.3%
FTSE/JSE Shareholder Weighted Index (SWIX)	-7.4%	-10.6%	-5.5%	2.8%	5.6%	5.9%	4.8%	9.3%
FTSE/JSE Capped Swix Index (Capped SWIX)	-7.5%	-10.6%	-4.6%	6.9%	6.8%	5.9%	4.6%	9.1%
FTSE/JSE All-Share Top 40 Index	-8.1%	-11.8%	-8.5%	4.6%	8.6%	9.3%	7.2%	10.7%
FTSE/JSE SWIX Top 40 Index	-7.4%	-10.5%	-4.9%	2.1%	5.5%	5.9%	4.6%	9.4%
FTSE/JSE Mid Cap Index	-9.4%	-12.7%	-6.6%	3.9%	4.5%	4.5%	4.3%	7.6%
FTSE/JSE Small Cap Index	-7.3%	-5.5%	-1.7%	19.5%	15.0%	6.4%	5.6%	10.3%
FTSE/JSE Listed Property Index (SAPY)	-10.3%	-11.6%	-12.7%	0.2%	-9.0%	-7.3%	-3.5%	2.7%
FTSE/JSE Capped Listed Property Index	-10.6%	-12.2%	-13.6%	-0.2%	-10.8%	-10.0%	-6.4%	1.1%
Local Interest-Bearing Indices								
FTSE/JSE All-Bond Index (ALBI)	-3.1%	-3.7%	-1.9%	1.3%	5.8%	7.8%	7.4%	7.2%
FTSE/JSE All-Bond Index 1–3 years	-0.9%	0.0%	1.3%	4.3%	6.5%	7.7%	7.8%	7.1%
FTSE/JSE All-Bond Index 3–7 years	-1.4%	-0.5%	0.3%	2.6%	7.5%	8.5%	8.6%	7.8%
FTSE/JSE All-Bond Index 7–12 years	-3.3%	-3.4%	-2.3%	0.2%	6.1%	8.0%	7.8%	7.3%
FTSE/JSE All-Bond Index +12 years	-3.6%	-5.2%	-2.5%	1.4%	5.3%	7.5%	7.0%	7.1%
Inflation-Linked Government Bonds (IGOV)	-1.0%	3.0%	3.2%	10.8%	7.2%	5.4%	5.0%	6.3%
Short-Term Fixed Interest Composite Index (SteFi)	0.4%	1.2%	2.2%	4.2%	5.0%	5.9%	6.3%	6.1%
Inflation Index								
Consumer Price Index (1 month lagged)	0.7%	2.3%	3.1%	6.5%	4.6%	4.5%	4.9%	5.1%
International Indices								
MSCI World Index	-4.6%	-6.7%	-18.6%	-2.2%	12.7%	13.1%	12.7%	17.9%
MSCI Emerging Market Index	-2.5%	-1.5%	-15.7%	-14.8%	5.8%	7.2%	7.5%	10.8%
FTSE World Government Bond Index (WGBI)	1.1%	1.2%	-13.0%	-5.4%	0.4%	3.3%	4.3%	6.4%
S&P Global Property	-4.1%	-7.2%	-17.6%	-1.3%	4.2%	7.1%	8.1%	13.0%
USA S&P 500	-4.3%	-6.8%	-18.3%	1.6%	16.0%	16.3%	15.9%	21.0%
UK FTSE 100	-4.9%	-0.8%	-9.0%	6.0%	6.0%	6.7%	5.9%	11.2%
Euro STOXX 50	-7.0%	-5.3%	-22.9%	-12.3%	4.1%	5.3%	6.1%	12.5%
Japan Nikkei 225	-4.1%	-5.3%	-19.8%	-13.0%	6.4%	8.4%	8.7%	15.2%
Currency Movement								
Rand/Dollar (R16.28 = 1 Dollar)	4.1%	11.4%	2.1%	13.9%	4.9%	4.5%	4.2%	7.1%
Rand/Euro (R17.06 = 1 Euro)	1.7%	5.5%	-5.9%	0.7%	2.1%	2.7%	3.3%	5.1%
JPY/Rand (8.34 Japanese Yen = 1 SA Rand)	1.3%	0.1%	15.6%	7.2%	2.9%	-0.6%	-2.7%	-1.6%
Rand/Pound (R19.83 = 1 Pound)	0.5%	3.3%	-8.1%	0.4%	3.5%	3.1%	0.5%	4.5%

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