ECONOMIC OVERVIEW

QUARTER 3, 2022

MENTENOVA

Contents

EXECUTIVE SUMMARY

Global financial markets remained under pressure during the third quarter, adapting to the reality of quicker tightening by global central banks and a bleaker economic outlook. Central banks' ongoing fight with inflation dominated headlines throughout the quarter, causing extreme levels of volatility across financial markets and leaving investors on edge.

Stocks returned to bear market territory in Q3 following a brief rally in July, with both emerging market and developed market equities ending the quarter in the red. South African equities also ended the quarter lower, while South African bonds managed to squeeze modest gains for the quarter despite the turmoil seen across global fixed income markets.

Currency markets were a major source of volatility during the quarter as the dollar continued its ascent, finding support from quickly rising interest rates in the US and fragile risk sentiment. The appreciation of the dollar has been painful for most other advanced and emerging market currencies, forcing some central banks to intervene in their financial markets to support their currencies.

A stronger dollar has also compounded the inflation problem for many other economies, putting further pressure on central banks to keep pace with the US Federal Reserve and combat inflation. While the Fed has already hiked interest rates by 300bps year-to-date, another 125ps worth of hikes is expected through the remainder of 2022, and the central bank's latest economic projections point to at least one more hike in 2023.

As financial conditions tighten, incoming economic data continues to indicate that the global economy is in a broad-based slowdown. According to the IMF's latest economic forecasts, global economic growth is expected to slow to 3.2% in 2022 from 6% in 2021, reflecting the shockwaves of Russia's invasion of Ukraine, rising interest rates, the normalization of fiscal policy and China's zero COVID policy.

South Africa is expected to slow alongside global peers; however, an unprecedented stint of loadshedding during the third quarter is dimming the outlook and remains a major headwind for the South African economy in the foreseeable future. The need for policy reform and swift action to address South Africa's structural challenges is more urgent than ever.

As we head into year-end, slower growth and rising interest rates continue to pose downside risks to traditional asset class valuations, and investor sentiment will remain sensitive to incoming economic data and communication from central banks as policymakers chart a difficult course. For investors, this means that market conditions could remain turbulent through the rest of 2022 and that the backdrop for risk assets may remain challenging. With that said, the recent market correction offers new investment opportunities and an attractive entry point for investors with a long-term view.

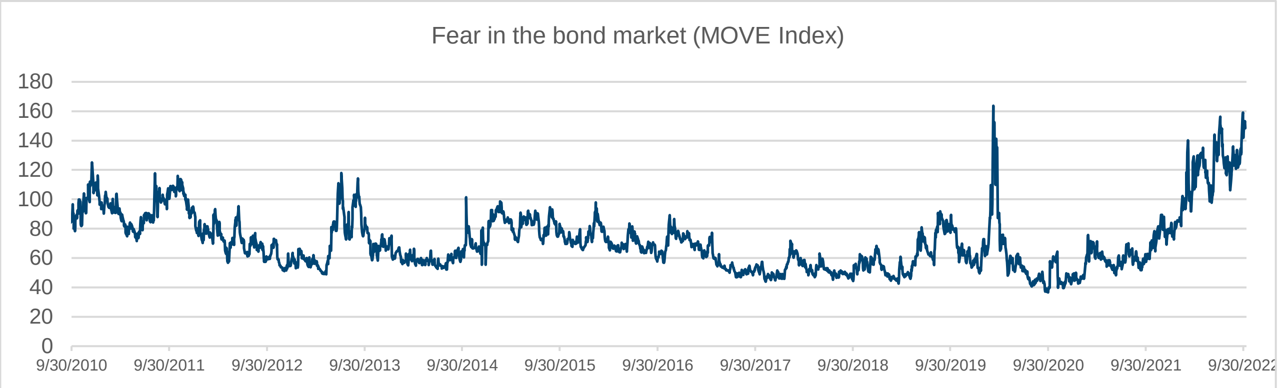
ECONOMIC AND MARKET OVERVIEW

EXTREME VOLATILITY ROCKS MARKETS

Global financial markets had another turbulent quarter, whipsawed by uncertainty surrounding inflation, monetary policy, and the outlook for the global economy. After a sharp rally in July, both stocks and bonds fell back into bear market territory during the latter part of the quarter, leaving investors disappointed.

Unprecedented levels of volatility were seen during the quarter as the markets reacted to faster and more aggressive interest rate hikes aimed at tackling stubbornly high inflation. Fear in the bond market was particularly elevated (reflected in the MOVE Index) as yields spiked, and bonds sold off in response to tightening liquidity conditions.

Chart 1: MOVE Index (last price) to 30 September 2022

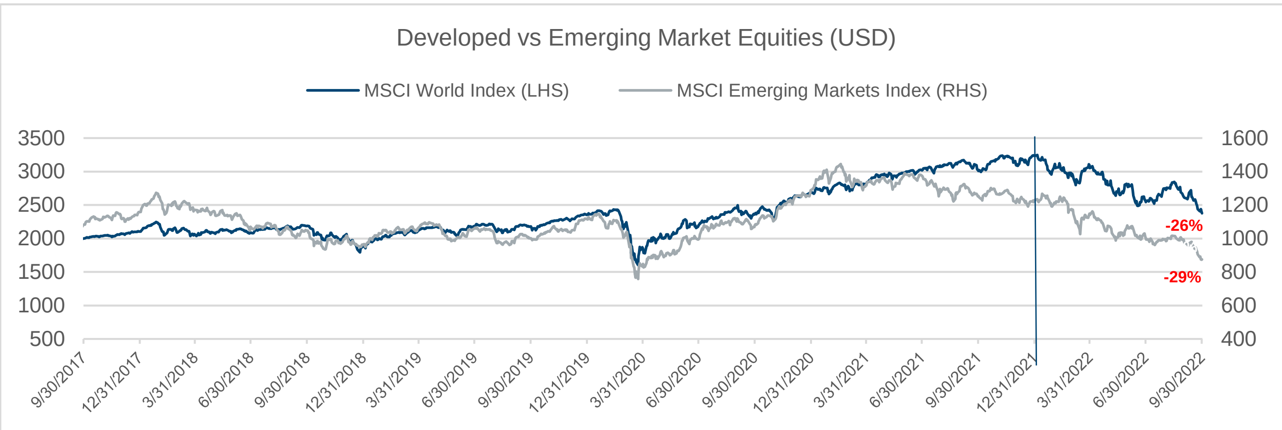


Source: Bloomberg

Global equity markets also ended the quarter broadly lower, with the bounce recorded early in the quarter proving unsustainable. As a result, most stocks extended the losses recorded in the first half of the year, with the MSCI World Index down another 6% in USD terms following double-digit losses in the first half.

Emerging market equities underperformed against their developed market peers, incurring losses of more than 11% in USD terms over the quarter, reflecting the headwinds faced by these economies as elevated food and energy prices bite and liquidity continues to be drained from the markets. On a year-to-date basis, DM equities were down 26% while EM equities were down 29% at the end of Q3 in USD terms.

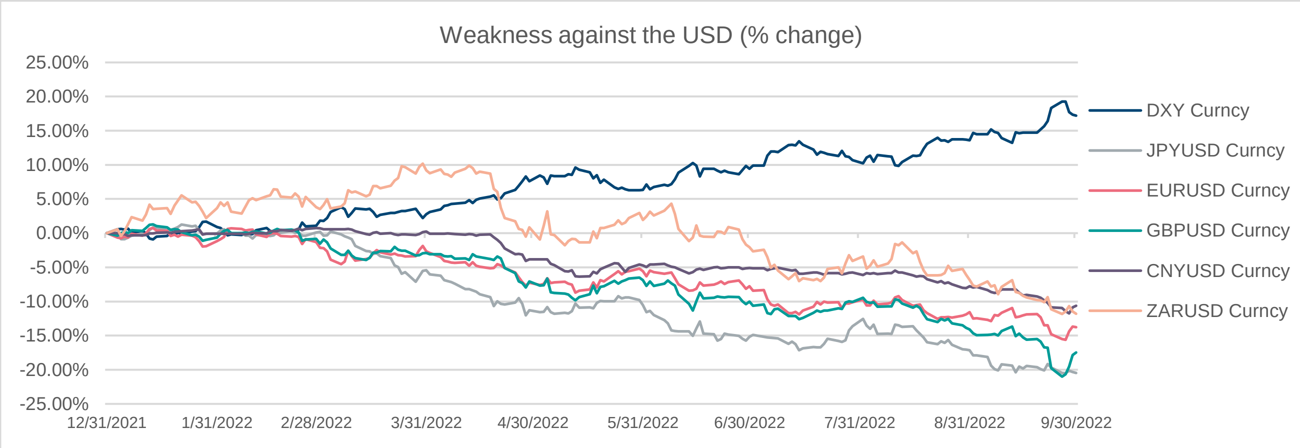
Chart 2: Performance of MSCI World Index & MSCI Emerging Markets Index in USD terms to 30 September 2022



Source: Bloomberg

A rampant US dollar has intensified headwinds for most other developed and emerging market economies and markets, adding to the turbulence across financial markets. Fundamental support for the USD from rapidly rising interest rates in the US, as well as the safe-haven appeal of the currency, has seen the currency gain close to 20% year to date, as reflected in the dollar index spot (DXY). Most major currencies have consequently weakened sharply against the greenback year to date, forcing some central banks to intervene in their financial markets.

Chart 3: % Year-to-date currency returns against the USD to 30 September 2022

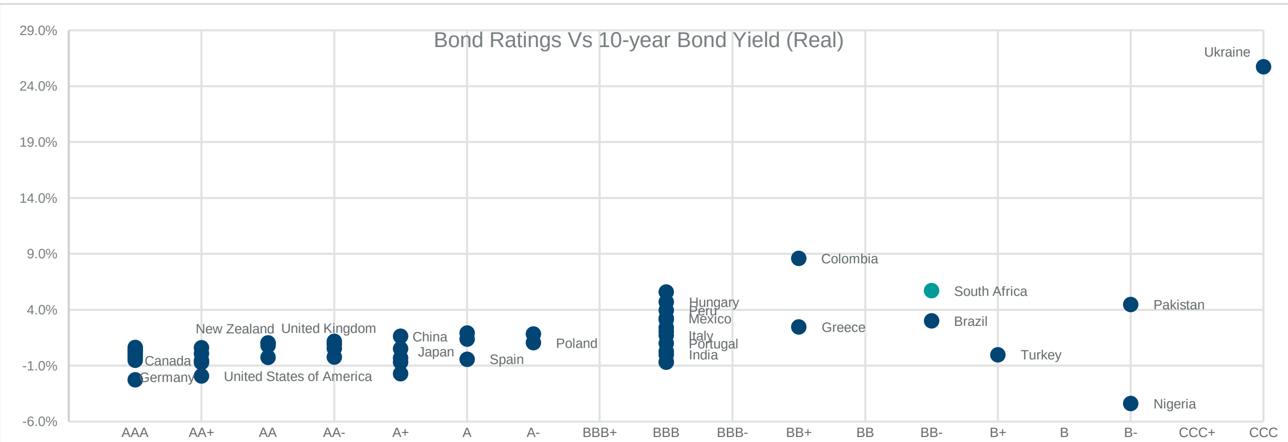


Source: Bloomberg

The Rand held up well during the first half of the year, buoyed by commodity prices. However, this trend saw a reversal during the third quarter as the local currency lost more than 11% against the USD, experiencing heightened levels of volatility alongside global FX markets. This resulted in the ZAR breaching R18/US$ for the first time in over two years, putting further upside pressure on inflation.

South African equities were not left unscathed by the deterioration in market sentiment over the course of the quarter, although losses were fairly mild following a modest rebound in resources and strong performance from select counters over the quarter, such as Thungela Resources (+ 70% in Q3), Absa Group (+18% in Q3) and Shoprite (+12% in Q3). At the end of the quarter, local equities, as measured by the capped SWIX Index, were down just over 2% in Rand terms. Meanwhile, local bonds held up well in the context of a tough quarter, returning just under 1%. This highlights the value that local bonds continue to offer investors despite elevated inflation and rising global rates, supported by the prudent policy actions of the South African Reserve Bank (SARB).

Chart 4: Bond ratings (x-axis) vs 10-year real bond yield (y-axis) for developed and emerging markets



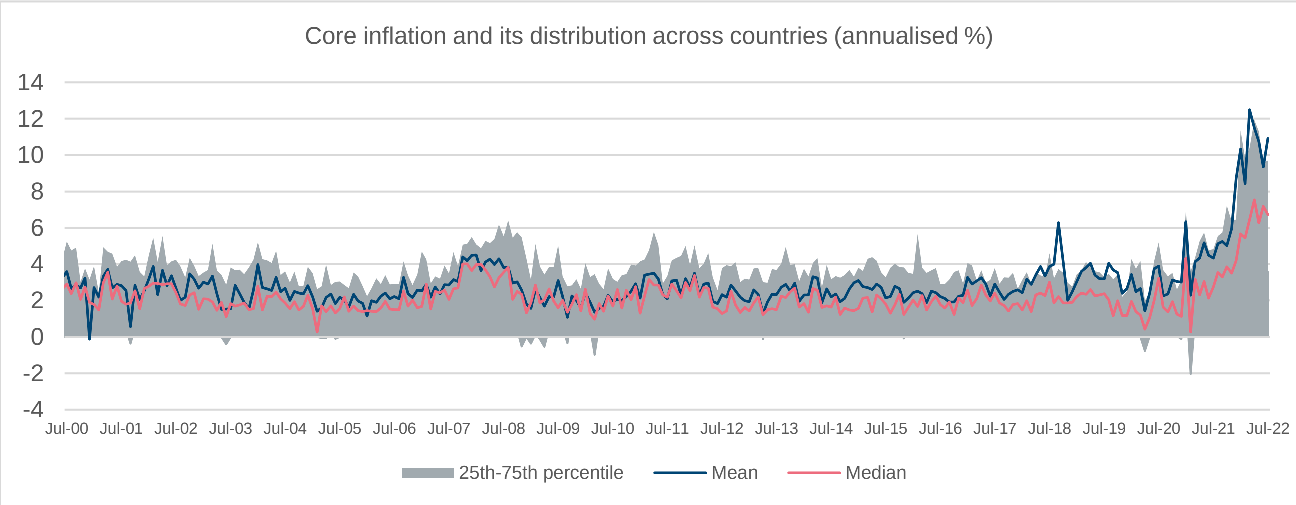
Source: Bloomberg

CENTRAL BANKS ACT FORCEFULLY TO TACKLE INFLATION

Upside inflation surprises persisted during the third quarter, prompting more aggressive moves from central banks. US inflation remained above 8% y/y, while inflation in the Euro area and the UK hovered close to 10% in both regions, which was well above central bank targets.

Although food and energy prices remain key drivers of inflation across the globe, underlying inflation continues to broaden out, as reflected in core inflation which excludes these volatile prices. This signals the second-round effects of the energy shock, supply chain pressures and tighter labour markets in advanced economies like the US.

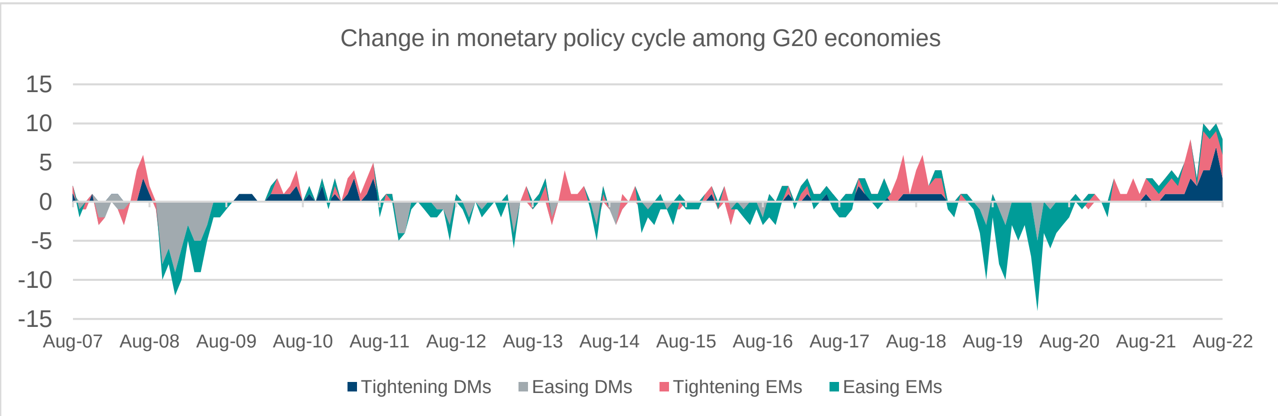
Chart 5: Annualised core inflation (%) and its distribution across countries



Source: Haver Analytics, IMF
Note: Countries included in group represent 81% of world GDP based on purchasing-power-parity weights

To prevent inflation from becoming entrenched, central banks have acted forcefully, and in many instances more aggressively than previously anticipated, keeping financial markets on edge. The US Federal Reserve has hiked rates by 3% so far this year in response to higher-than-anticipated inflation and labour market tightness, with the gap between nominal and real wage growth closing rapidly. Other central banks across both developed and emerging markets have followed suit, including South Africa's central bank, which has hiked the repo rate 6 consecutive times since November 2021 by a total of 2.75%. Among the G20 economies, the number of increases in policy rates continues to rise while central bank balance sheets continue to shrink.

Chart 6: Number of increases and cuts in policy rates among G20 economies to 31 August 2022

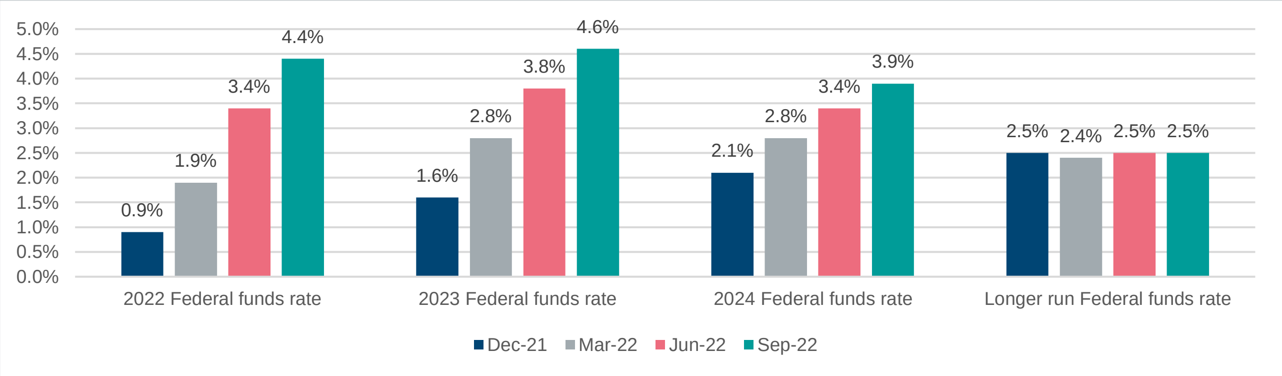


Source: Bloomberg Finance L.P., IMF

With inflation showing few signs of easing, central banks are expected to continue hiking rates through the remainder of 2022. However, the Fed surprised the markets during Q3 as Fed Chair Jerome Powell pushed back strongly on expectations that cuts are on the cards in 2023, which sent some shockwaves across the markets during the quarter.

This was reaffirmed by the Fed's September projections, which added another 100bps to rate expectations this year and include a rate hike in 2023 – thus sending a clear signal to the markets that the current hiking cycle is far from over as the Fed attempts to cool the labour market and bring inflation under control.

Chart 7: US Federal Reserve projections for Federal funds rate at September 2022



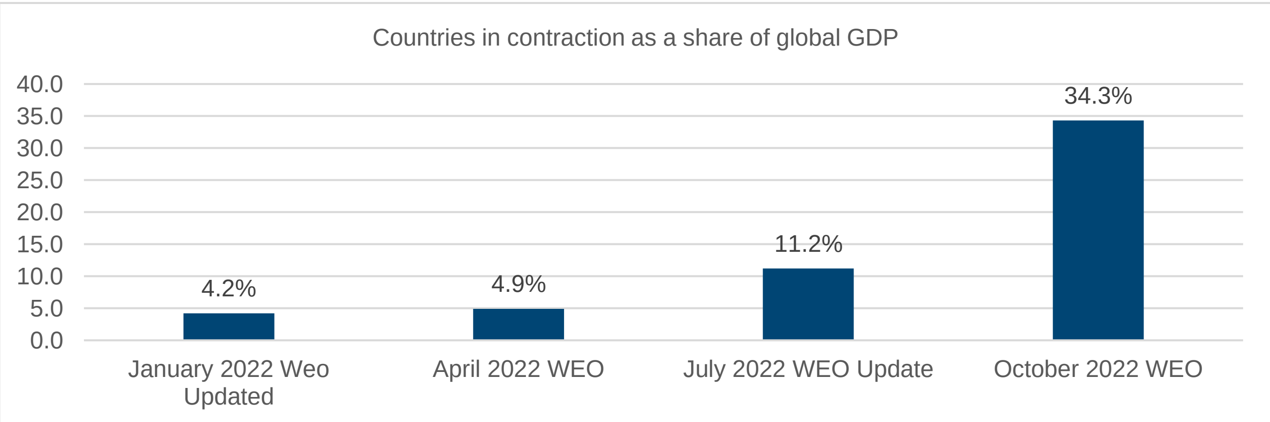
Source: Federal Reserve, Summary of Economic Projections September 2022

GLOBAL ECONOMY IN A BROAD-BASED SLOWDOWN

Economic data releases continue to indicate that the global economy is in a broad-based slowdown, reflecting the impact of Russia's invasion of Ukraine, China's zero-COVID policy and tighter financial conditions. However, the slowdown has been less severe than expected in certain regions, with Q2 GDP data out of Europe showing that the region expanded 0.8% q/q, supported by tourism during the summer season. Data out of the UK also surprised to the upside with the economy expanding modestly in Q2, thus helping to avoid a technical recession.

That said, growth out of China, Russia and the US was negative in Q2 and, according to the IMF World Economic Outlook (WEO), the percentage of countries in contraction as a share of global GDP has risen sharply.

Chart 8: Percentage of countries in contraction as a share of global GDP, 2022–23



Source: IMF World Economic Outlook (WEO) October 2022

While it is still unclear whether a full-blown global recession is on the horizon, the global economy is slowing down and the risks to the outlook remain skewed to the downside.

The ongoing war between Russia and Ukraine continues to inflict immense economic damage, affecting trade, production, consumer confidence and the cost of living. A key downside risk continues to stem from the tightening of gas supplies from Russia to Europe, especially as Europe goes into winter. The substantial reduction in gas flows through the Nord Stream 1 pipeline has pushed European energy prices to new heights, and the region is resorting to more liquefied natural gas imports and the reactivation of coal-fired power stations to navigate the ongoing energy crisis. The risk of supply shortfalls and disruptions to energy supply across the Euro area could weigh heavily on growth in the region through the remainder of the year, with the potential for negative cross-border spillover effects.

Chart 9: Russian pipeline gas supplies to EU by route

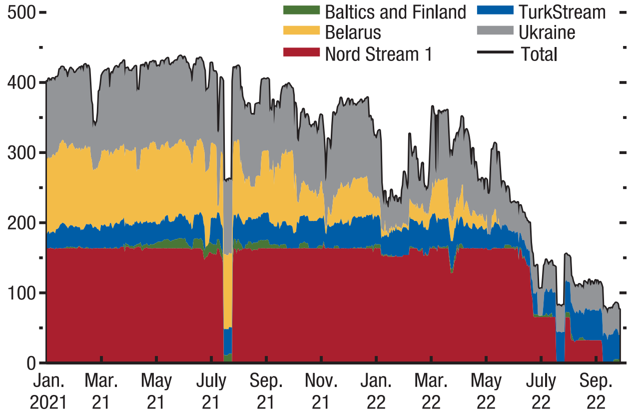
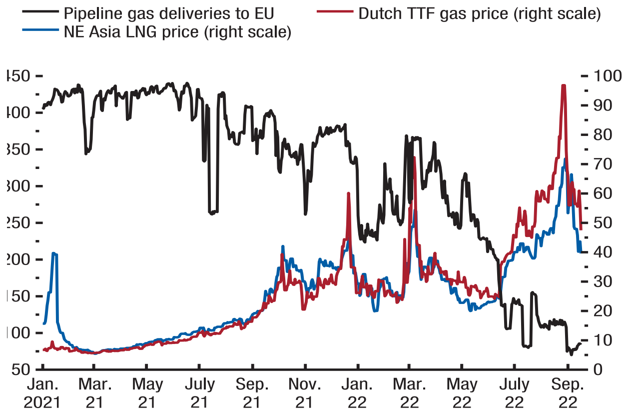


Chart 10: Russian Gas Exports and Prices

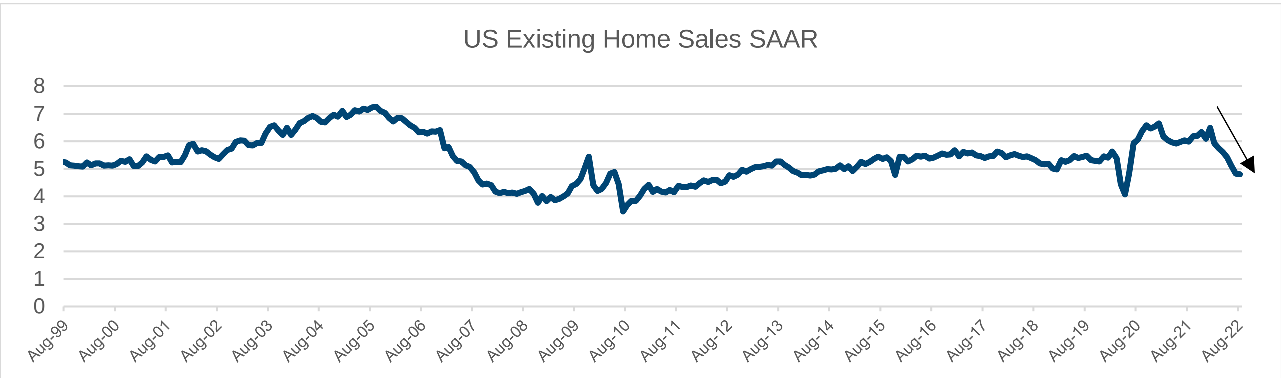


Sources: European Network of Transmission System Operators for gas; Gas Transmission System Operator of Ukraine, IMF, Refinitiv, Datastream, Argus Media

Meanwhile, growth in China has already slowed significantly since the start of the year, impacted by harsh lockdowns and weaker trade. Signs of severe distress in the country's real estate market continue to pose major downside risks to the economy, especially since the real estate sector makes up around 20% of GDP in the country.

Finally, the risk of overtightening by major central banks continues to pose a risk to the outlook as interest rates climb and liquidity conditions tighten. Activity in the US housing market, for instance, has already shown signs of slowing sharply as higher rates have sapped demand and worsened affordability, with attendant economic repercussions. While housing is an interest rate-sensitive area of the economy, overtightening could tip the broader economy into recession.

Chart 11: US housing activities, seasonally adjusted annual rate of existing home sales to 31 August 2022



Source: Bloomberg

While central banks want to avoid a recession, the risk of spiralling inflation could be far more detrimental, and central banks are thus expected to remain committed to quelling inflation and keeping inflation expectations anchored.

SOUTH AFRICA LEFT IN THE DARK

Following a real GDP decline of 0.7% in Q2, the outlook for the South African economy looks even bleaker as the end of the year approaches, with recent data releases suggesting that manufacturing conditions and sentiment deteriorated in the third quarter.

Chart 12: Seasonally adjusted Absa Purchasing Managers Index (index points) to 30 September 2022

Source: Bureau for Economic Research

The local economy continues to buckle under the pressure of rolling blackouts amid an unprecedented wave of power outages during the third quarter, particularly in the latter half of the quarter, with data from Eskom indicating that 572 of September's 720 hours were directly affected. Analysis by Eskom's Research, Testing and Development department revealed that, aside from 2021, more power cuts were experienced in September 2022 than in any other year since loadshedding started in 2007.

While many parts of the economy have learnt to adapt to rolling blackouts, the economy is estimated to lose close to R1bn a day during stage 4 loadshedding and more than R1.5bn a day during stage 6 loadshedding (Nova Economics estimates). Although difficult to quantify the true cost to the economy, the loss of economic activity, jobs and investment in the country is glaringly apparent and continues to plague the outlook for the domestic economy.

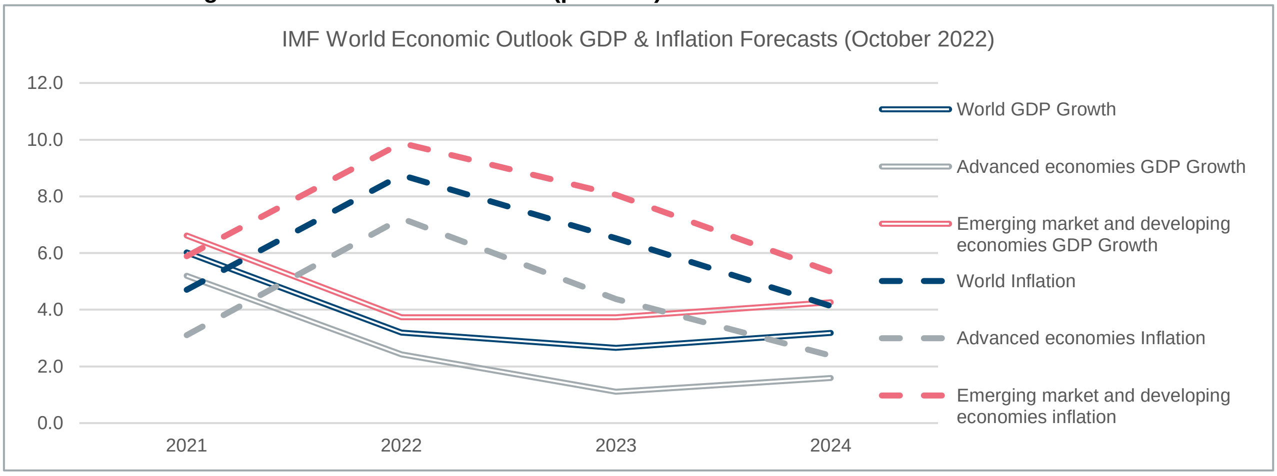
The ongoing energy crisis saw President Ramaphosa put his weight behind an 'energy action plan' during the third quarter, which included the announcement of a raft of measures intended to relieve pressure on the national grid, such as removing barriers to generation capacity and unlocking energy from different sources. While this move is encouraging, swift action is desperately needed to achieve energy security in the country,

It is against this backdrop, and a worsening global outlook, that the South African Reserve Bank revised its forecast for 2022 GDP growth down to 1.9% from 2.0% previously, while the IMF lowered its forecast for South Africa's 2022 GDP growth from 2.3% to 2.1%. The IMF meanwhile forecasts that the economy will grow by 1.1% in 2023, down from its 1.4% forecast in July.

LOOKING AHEAD

As we head into the final months of 2022, financial market volatility is expected to persist, reflecting the uncertainty that clouds the overall outlook. With inflationary pressures showing few signs of abating, central banks are expected to remain steadfast in their efforts to bring inflation under control and prevent the de-anchoring of inflation expectations. At the same time, economic activity is slowing down, with energy security concerns, fractured economic relations and tighter financial conditions among the key downside risks to the global economy.

Chart 13: Global growth and inflation forecasts (per cent)



Source: IMF World Economic Outlook (WEO) October 2022

Although inflation is expected to cool as we head into 2023, the end of the monetary policy tightening cycle still appears to be a long way off, and the risk of policy errors remains as central banks chart a difficult course.

It is against this backdrop that investor sentiment will remain sensitive to incoming economic data and communication from central banks through the remainder of this year, while corporate margins will be in the spotlight as slower growth and rising input costs pose risks to elevated margins. At the same time, short-term yields could continue to rise as the monetary policy tightening cycle gains momentum. Finally, yield spreads could be driven even higher, especially for debt-distressed economies which are grappling with rising financing costs and a strong USD.

APPENDIX

Financial market performance at 30 September 2022 (ZAR)

Index	1 Month	3 Months	YTD	1 Year	3 Year (p.a.)	5 Year (p.a.)	7 Year (p.a.)	10 Year (p.a.)
Local Equity Indices								
FTSE/JSE All-Share Index (ALSI)	-4.1%	-1.9%	-10.1%	3.5%	9.2%	6.5%	7.0%	9.5%
FTSE/JSE Resources 20 Index	1.3%	-2.1%	-9.7%	10.4%	18.0%	17.2%	14.5%	6.7%
FTSE/JSE Industrials Index	-6.4%	-1.3%	-16.8%	-3.4%	5.6%	2.1%	3.7%	9.5%
FTSE/JSE Financials Index	-6.0%	-4.2%	-5.3%	-2.0%	0.5%	1.0%	1.6%	7.2%
FTSE/JSE Shareholder Weighted Index (SWIX)	-3.9%	-2.4%	-7.8%	-0.2%	6.3%	3.9%	5.1%	8.3%
FTSE/JSE Capped Swix Index (Capped SWIX)	-3.8%	-2.4%	-7.0%	1.1%	7.8%	4.2%	4.8%	8.1%
FTSE/JSE All-Share Top 40 Index	-4.4%	-2.7%	-11.0%	3.4%	9.5%	6.7%	7.0%	9.6%
FTSE/JSE SWIX Top 40 Index	-4.2%	-3.4%	-8.2%	-0.9%	6.1%	3.6%	4.6%	8.2%
FTSE/JSE Mid Cap Index	-2.8%	0.7%	-5.9%	-2.3%	5.4%	3.9%	5.3%	7.1%
FTSE/JSE Small Cap Index	-2.0%	4.7%	3.0%	12.0%	18.1%	6.8%	6.9%	10.2%
FTSE/JSE Listed Property Index (SAPY)	-6.3%	-3.5%	-15.8%	-8.7%	-8.7%	-9.0%	-4.8%	1.2%
FTSE/JSE Capped Listed Property Index	-6.6%	-4.3%	-17.3%	-10.4%	-10.7%	-11.4%	-8.1%	-0.3%
Local Interest-Bearing Indices								
FTSE/JSE All-Bond Index (ALBI)	-2.1%	0.6%	-1.3%	1.5%	5.7%	7.1%	7.4%	6.7%
FTSE/JSE All-Bond Index 1 - 3 years	-0.1%	0.7%	2.0%	3.4%	6.3%	7.2%	7.6%	7.0%
FTSE/JSE All-Bond Index 3 - 7 years	-0.8%	0.4%	0.7%	1.8%	7.2%	7.9%	8.4%	7.4%
FTSE/JSE All-Bond Index 7 - 12 years	-1.6%	0.8%	-1.5%	0.8%	6.0%	7.4%	7.8%	6.8%
FTSE/JSE All-Bond Index +12 years	-2.9%	0.6%	-2.0%	2.0%	5.3%	6.8%	6.9%	6.5%
Inflation Linked Government Bonds (IGOV)	-2.3%	-1.2%	2.0%	7.3%	6.7%	4.9%	4.7%	5.3%
Short-Term Fixed Interest Composite Index (SteFi)	0.5%	1.3%	3.6%	4.6%	4.9%	5.8%	6.3%	6.1%
Inflation Index								
Consumer Price Index (1 month lagged)	0.2%	2.8%	6.0%	7.6%	5.2%	5.0%	5.1%	5.3%
International Indices								
MSCI World Index	-4.2%	4.3%	-15.1%	-3.4%	11.4%	12.1%	12.7%	17.5%
MSCI Emerging Market Index	-6.7%	-1.6%	-17.1%	-13.7%	4.2%	4.4%	8.3%	9.6%
FTSE World Government Bond Index (WGBI)	0.2%	2.7%	-10.7%	-6.9%	-1.4%	2.7%	2.5%	6.2%
S&P Global Property	-7.6%	-1.8%	-19.1%	-7.5%	0.0%	5.2%	6.4%	12.0%
USA S&P 500	-4.1%	5.7%	-13.6%	1.1%	14.7%	15.7%	15.7%	20.8%
UK FTSE 100	-4.1%	-1.2%	-10.1%	-0.2%	3.8%	4.7%	5.3%	10.2%
Euro STOXX 50	-2.9%	-0.1%	-22.9%	-14.9%	2.0%	2.8%	5.5%	11.2%
Japan Nikkei 225	-5.8%	3.3%	-17.1%	-17.1%	4.0%	7.9%	9.1%	15.3%
Currency Movement								
Rand/Dollar (R18,09= 1 Dollar)	5.6%	11.1%	13.5%	20.0%	6.1%	5.9%	3.9%	8.1%
Rand/Euro (R17,74= 1 Euro)	3.1%	3.9%	-2.2%	1.6%	2.4%	2.1%	2.0%	5.2%
JPY/Rand (8 Japanese Yen= 1 SA Rand)	-1.5%	-4.0%	10.9%	8.4%	3.9%	-0.7%	-1.1%	-1.6%
Rand/Pound (R20,21= 1 Pound)	1.6%	1.9%	-6.4%	-0.5%	2.8%	2.2%	-0.5%	4.2%

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