ECONOMIC OVERVIEW

QUARTER 4, 2022

MENTENOVA

Contents

EXECUTIVE SUMMARY

It is safe to say that most investors are feeling relieved that 2022 is now behind them, after a turbulent year which saw most asset classes decline sharply. There was, however, a reprieve in the final quarter of the year as markets broadly rebounded on the back of signs that inflation may be easing as well as the decision by China to relax its zero-COVID policy.

Emerging market and developed market equities finished the quarter close to 10% higher in local currency terms, despite a loss of momentum in December, while South African equities recorded gains of more than 12% over the same period. With a lot of bad news already priced in, the markets found some support from an improved risk appetite, with South African assets being a beneficiary of the recovery in sentiment for the quarter, including SA bonds (+5.7% in Q4) and SA property (+18.3% in Q4). The ZAR also staged a recovery against the USD in the final quarter as the dollar weakened, offsetting the political noise and negative news emanating from the country in the final months of 2022.

Inflation and monetary policy remained dominant themes in the fourth quarter as investors looked for clues as to what monetary policymakers might do next. Markets were encouraged by signs that inflation may be easing, reflecting softer commodity prices (specifically energy) and weaker demand, while a decline in the proportion of countries experiencing rising inflation saw markets pricing in less aggressive monetary policy tightening for 2023.

Even though the data suggests that inflation may be trending lower, central banks across the globe have reiterated their commitment to price stability; thus, interest rates are expected to continue to rise in the near term, which could keep some pressure on markets as we venture further into 2023. Tighter monetary policy has also contributed to a deterioration in global financial conditions and economic activity, with the global economy expected to slow significantly this year.

Over and above these global headwinds, South Africa is facing additional downside pressure from electricity constraints and policy uncertainty, both of which continue to hinder economic recovery. Low diesel reserves and repetitive breakdowns at several major power plants have left the economy in a dire position at the start of the year. It is becoming increasingly urgent for the government to find solutions to the energy crisis and implement much-needed structural reforms.

High inflation, rising interest rates and slower growth continue to shape the landscape as 2023 unfolds, while geopolitical risk and concerns surrounding energy security remain elevated. Although there is no certainty that we have seen the worst of the recent market downturn, opportunities continue to present themselves for long-term investors. Should the outlook for global economic growth and inflation improve as 2023 progresses, there could be meaningful rewards in store for investors.

While we are cautiously optimistic that 2023 presents opportunities for investors, there are a few binary events that could significantly influence the markets and we encourage our investors to remain focused on their long-term objectives and stay the course.

ECONOMIC AND MARKET OVERVIEW

MARKETS ROUND OFF 2022 WITH GAINS IN Q4

With plenty of bad news already priced into the markets, investor sentiment improved in the final quarter of the year as inflation showed signs of easing and China partially relaxed its COVID policy. Global markets were broadly higher for the quarter, despite losing some momentum in December, with the MSCI World Total Return Index and MSCI EM Total Return Indices up 9.9%% and 9.8% respectively in local currency terms. This helped offset some of the losses recorded for 2022, although most equities still finished in the red following a tumultuous year for risky assets.

Chart 1: Major equity market returns for the year ended 31 December 2022 (local currency)

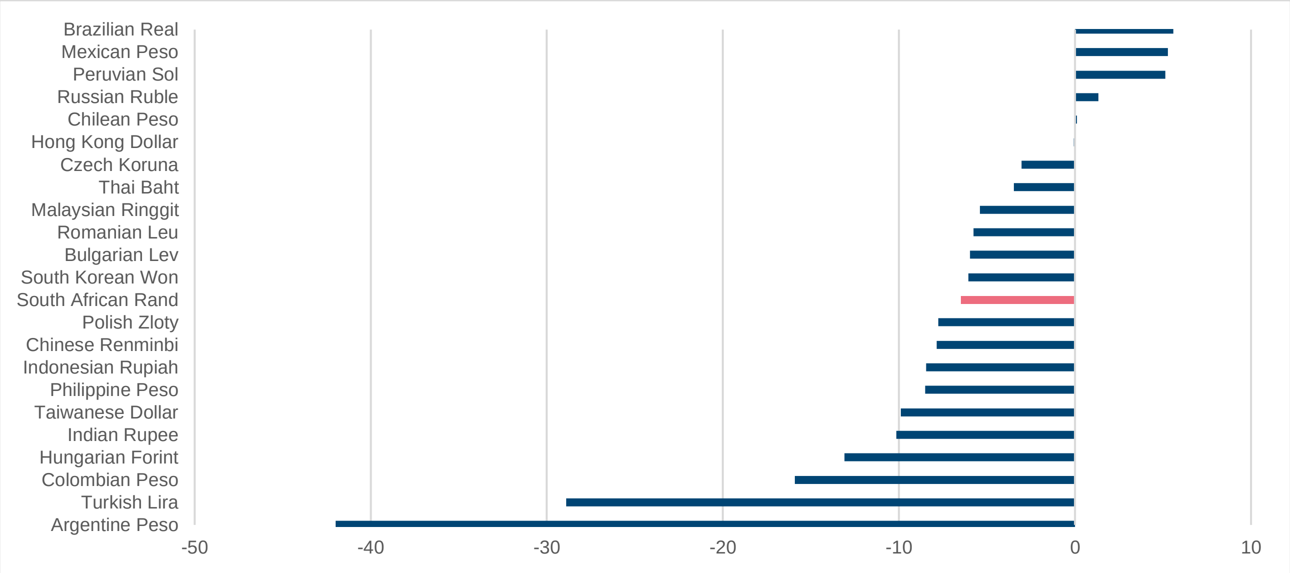
Source: Bloomberg

The South African equity market was a standout performer amongst emerging markets for the year after racking up gains of 12.2% (capped SWIX) for the fourth quarter. All major sectors advanced in the final three months, led by resources, which added 18% (Resource 20 Index). Financials and industrials also produced double-digit returns for the quarter, supported by a strong performance by index heavyweights Naspers and Prosus, which both gained close to 25%.

The local bond market also ended the quarter on a positive note, despite some intra-month volatility in December due to news of the possible impeachment of President Cyril Ramaphosa in the wake of allegations that he neglected to report a theft at his Phala Phala farm. However, these concerns subsided following the president's re-election as leader of the ANC.

Political noise during the final quarter of the year kept ZAR volatility elevated, but the currency ended the quarter on a firmer footing against the USD as the latter lost some momentum after reaching its highest levels in almost two decades. This helped the local currency to regain some lost ground in the prior quarter, ending the year near the middle of the emerging market currency basket, against the strongest dollar that the world had seen in several years.

Chart 2: Emerging market currency performance against the USD for the year ended 31 December 2022

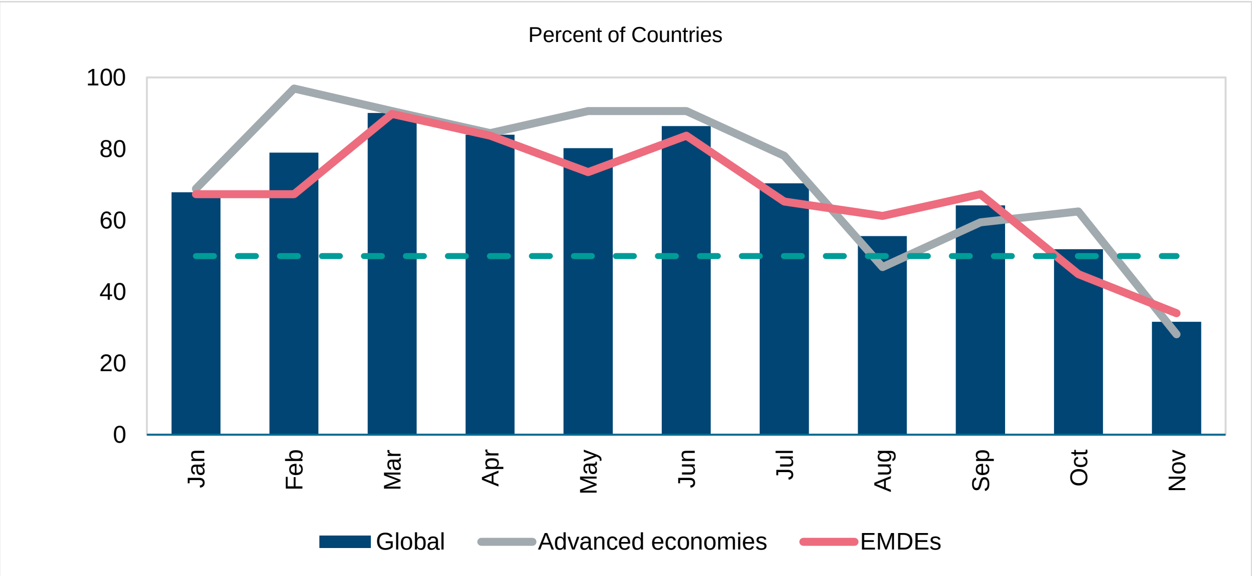


Source: Bloomberg

INFLATION SHOWS SIGNS OF EASING

Inflation remained the dominant theme during the final quarter. The markets were encouraged by signs that inflation may be easing, reflecting softer commodity prices (specifically energy) and weaker demand. This was evidenced by a slowdown in the proportion of countries experiencing rising inflation in the final quarter, a trend boosting expectations that central banks could slow the pace of interest rate hikes into 2023.

Chart 3: Share of economies with rising inflation for the period Jan 2022–Nov 2022



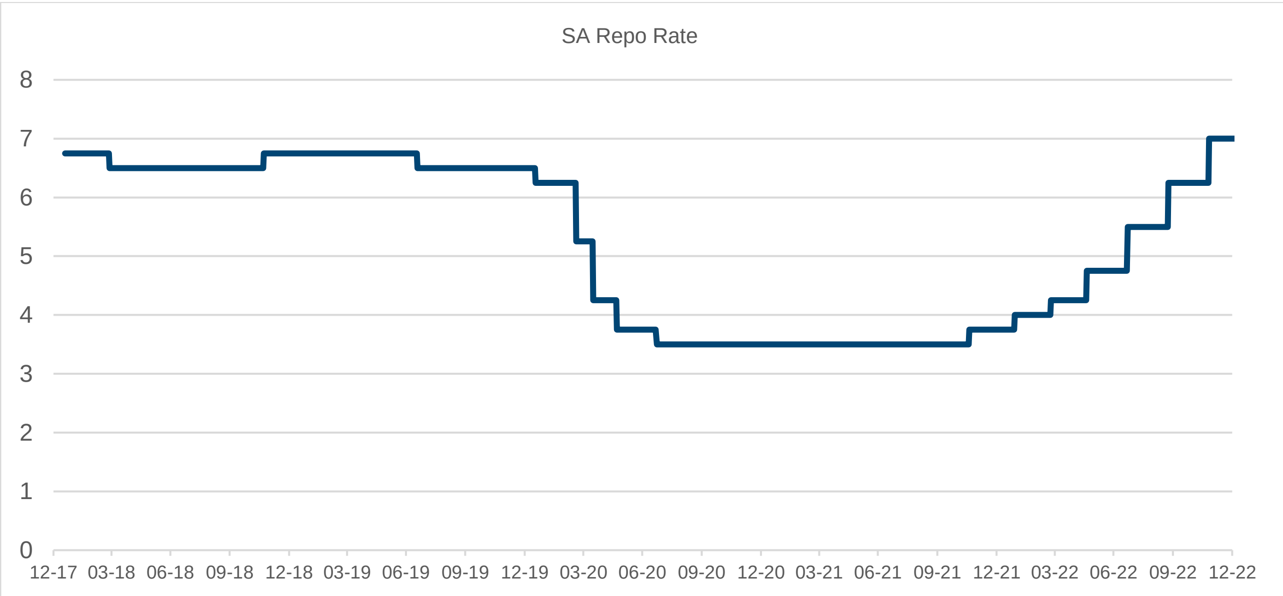
Sources: Haver Analytics; World Bank

Despite signs that inflation may be slowing, there is still uncertainty surrounding the persistence of core inflation (inflation excluding volatile food and energy prices), the impact of wage growth and elevated short-term inflation expectations. Central banks thus remain committed to bringing inflation back towards target levels, and interest rates continue to trend higher.

It is against this backdrop that the US Federal Reserve ended the year with another 50bps worth of interest rate hikes and signalled that further rate hikes could be expected in 2023. Specifically, the Fed now projects that US interest rates will rise to 5.1% in 2023 before cuts in 2024, with other global central banks expected to follow suit. That said, the market is of the view that rate cuts could come earlier than 2024.

The South African Reserve Bank (SARB) also ended the year with another 75bps worth of rate hikes, taking the repo rate to 7%, which is above pre-pandemic levels. During the year, the SARB hiked interest rates by a total of 3.25% to contain price pressures, protect the value of the currency and ensure inflation expectations remained anchored around the mid-point of the target band. While domestic inflation has slowed in recent months, upside risks to local inflation still exist in 2023, including the contentious decision by the energy regulator to approve an 18.6% increase in electricity tariffs for the 2023/24 financial year. In addition, persistent load shedding continues to have knock-on effects for food producers who cannot produce enough food, which could drive food prices higher and keep pressure on the SARB to tighten monetary policy.

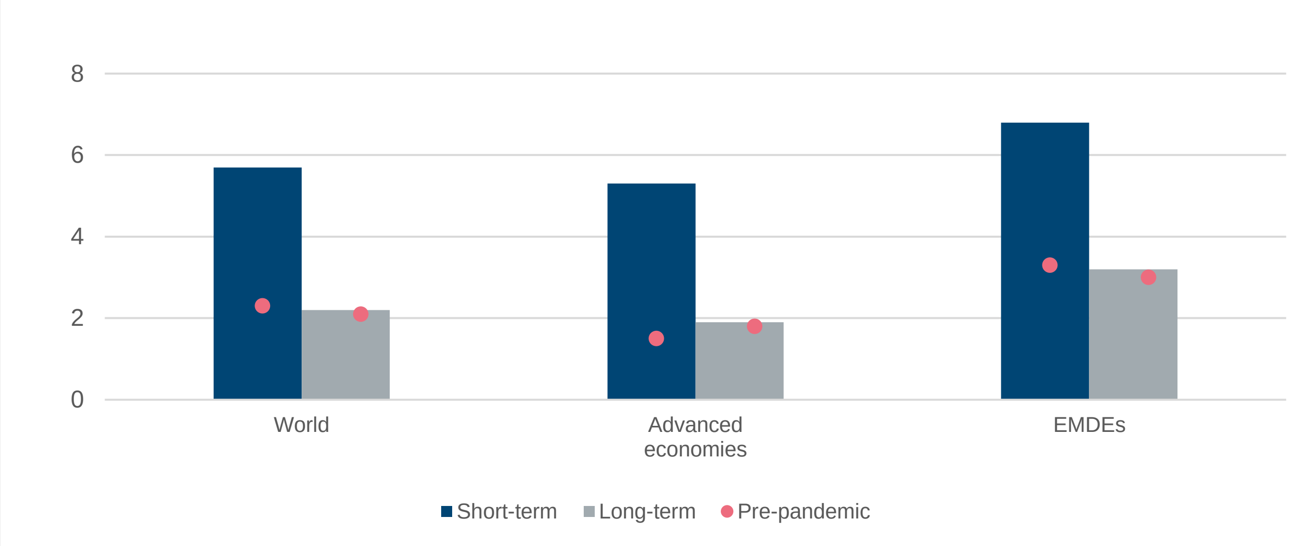
Chart 4: South Africa's repo rate over the past 5 years



Source: Bloomberg

Keeping inflation expectations anchored remains a key priority for central banks across the globe as it prevents financial market shocks and spiralling inflation. While short-term inflation expectations remain elevated, the aggressive monetary policy response to the sharp spike in inflation in 2022 has helped to keep long-term inflation expectations anchored near pre-pandemic levels.

Chart 5: Short- and long-term inflation expectations (percent) across advanced economies, emerging and developing economies and the World

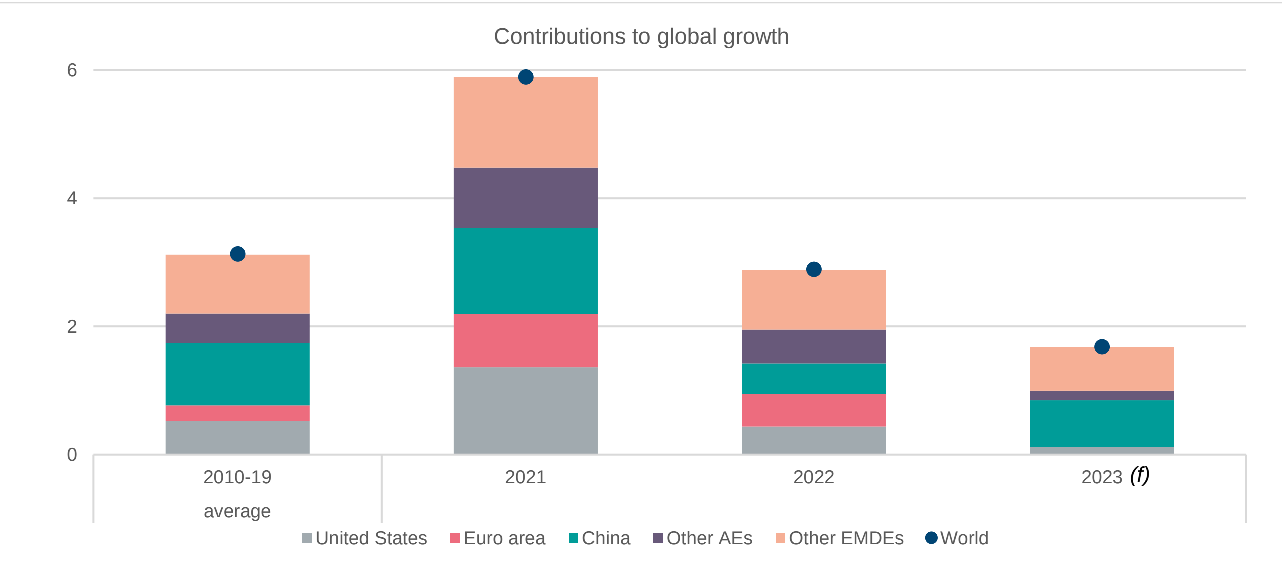


Source: Consensus Economics, World Bank
Note: EMDEs = emerging market and developing economies. Median one-year-ahead (short-term) and five-year-ahead (long-term) CPI Inflation expectations for up to 33 advanced economies and 50 EMDEs, based on December 2022 surveys. PINK DOTS indicate pre-pandemic levels based on January 2020 surveys.

GLOBAL GROWTH CONTINUES TO TREND LOWER

While tighter monetary policy has been necessary to contain price pressures, it has contributed to a deterioration in global financial conditions and economic activity. According to the World Bank, global economic growth is expected to decline from 2.9% in 2022 to 1.7% in 2023, which is significantly lower than the forecast of 3% six months earlier. This reflects the impact of faster-than-expected monetary policy tightening, weaker demand, elevated inflation, and energy supply constraints in regions such as Europe. Current forecasts suggest that the US, China, and the Euro area are all expected to grow by well below their 10-year averages, with all major economies expected to contribute less to overall global growth in 2023 compared to the past decade.

Chart 6: Contributions to global growth since 2010



Source: World Bank.

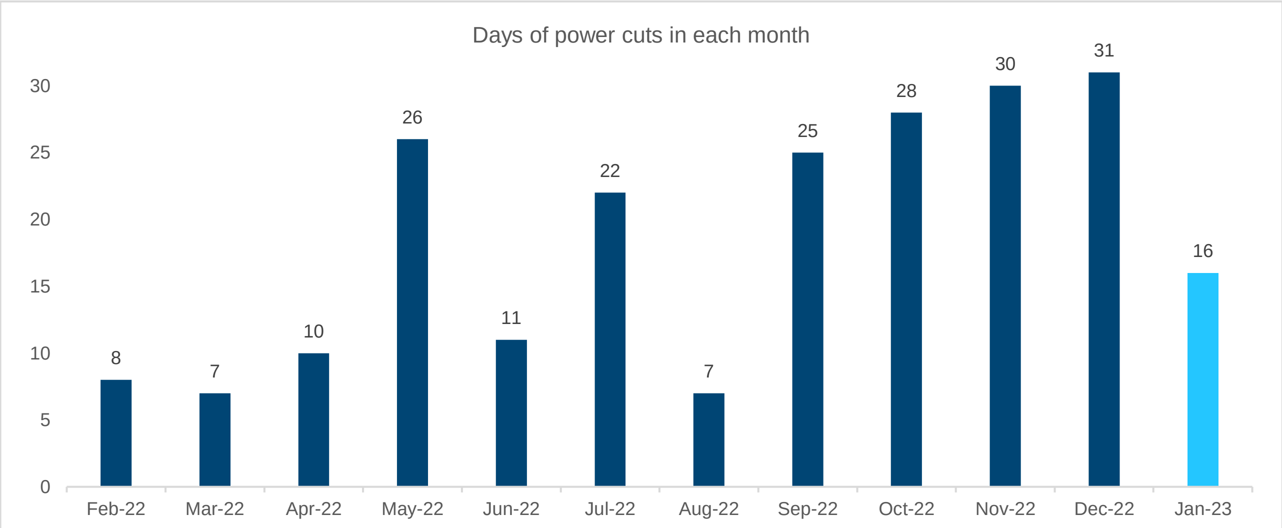
Note: AEs = advanced economies; EMDEs = emerging market and developing economies. Aggregates are calculated using real US dollar GDP weights at average 2010–19 prices and market exchange rates. Data for 2023 are forecasts.

While most economies are projected to slow in 2023 compared to last year, China is expected to contribute more to global economic growth this year due to the lifting of pandemic-related restrictions as well as policy easing. However, weaknesses in the country's real estate sector and ongoing disruptions from COVID-19 continue to pose downside risks to the economy.

DOMESTIC ECONOMY CRIPPLED BY THE ENERGY CRISIS

Domestically, the SARB expects the South African economy to slow from 1.8% in 2022 to 1.1% this year due to slower global growth as well as local structural challenges, the most notable being the energy crisis. Following 208 days of load shedding in 2022, the outlook remains grim for 2023, as Eskom grapples with low diesel reserves and repetitive breakdowns at major power-generating units. The resignation of Group CEO, Andre de Ruyter, has added further insult to injury, leaving Eskom without stable leadership at a critical time.

Chart 7: Number of days of load shedding per month from Feb 2022 to 16 Jan 2023



Source: Eskom, Bloomberg

With the domestic outlook clouded by electricity constraints and other structural challenges, policymakers are desperate for solutions to shore up the economy. It is in this context that talk of broadening the central bank's mandate to play a bigger role in driving economic growth resurfaced at the ANC's national conference at the end of 2022. While this would require a constitutional amendment and has been downplayed by President Ramaphosa, any threats to the SARB's independence and credibility pose downside risks to South African assets.

Another risk to South African markets in the shorter term stems from the impact of a potential greylisting after the Financial Action Task Force (FATF) found last year that measures to combat money laundering and the financing of terrorism in South Africa were inadequate. The government has responded by implementing two key pieces of legislation to address these shortcomings, but it remains to be seen whether this will be sufficient to prevent the country from being placed on the greylist. A decision by the FATF is expected in February, and investors will be closely watching the outcome of this decision. Other countries that have been greylisted have experienced capital outflows, higher funding costs and reputational damage.

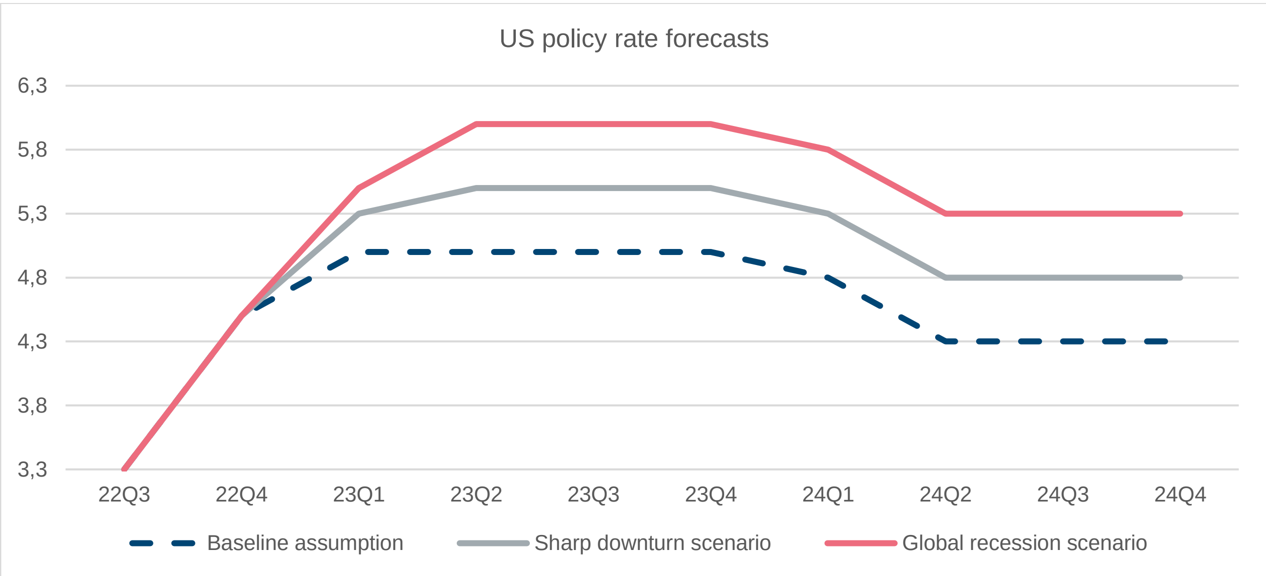
LOOKING AHEAD

2022 was a challenging year for investors as virtually all asset classes declined on the back of high inflation, rising interest rates and slowing growth. These themes continue to shape the landscape as we move into 2023, and questions surrounding the persistence of inflation and the extent of further monetary policy tightening remain top of mind for investors. While there is no certainty that we have seen the worst of the recent market downturn, plenty of bad news has already been priced in by investors and opportunities continue to present themselves for long-term investors. We unpack below some of the major themes we expect to drive economies and markets in 2023:

Interest rates will continue to trend up, but there may be an end in sight

With inflation still elevated across the globe at the start of 2023, interest rates are expected to continue to trend higher in the short term. Indications from the US Federal Reserve are that there could be another 50–75bps worth of hikes in the US this year before cuts in 2024 and other global central banks are expected to follow suit. Although the US Federal Reserve bears the risk of overtightening and tipping the US economy into recession, price stability remains the priority of central banks, and tighter monetary policy is expected to remain a major theme this year.

Chart 8: US policy rate forecasts under different scenarios

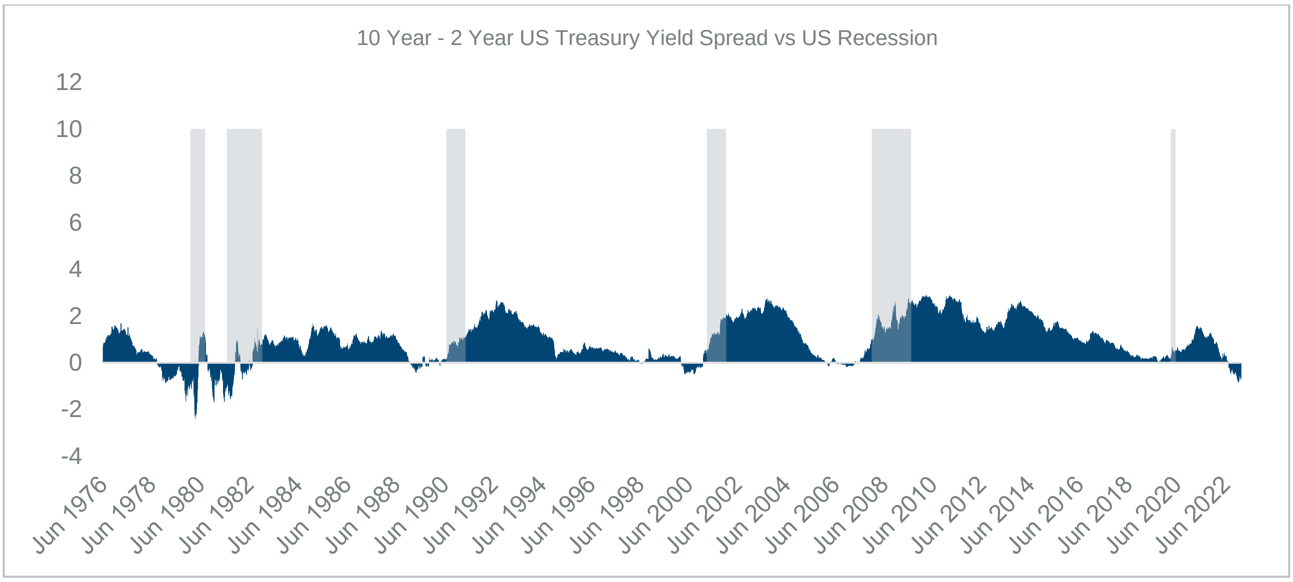


Sources: Bloomberg; Oxford Economics; World Bank.
Note: Scenarios produced using the Oxford Economics Global Economic Model. Data are estimates for 2022 and forecasts for 2023–24. Start-2022 market expectations are derived from future overnight index swaps (OIS) curves, observed on December 31, 2021. Baseline interest rate assumptions consistent with market expectations through 2023Q3. Beyond 2023, baseline assumptions are broadly in line with the Federal Open Market Committee's summary of economic projections as of December 14th, 2022.

Recession or no recession, growth is going to be slower this year

Tighter financial conditions have exerted downward pressure on global growth, and most economies are expected to slow this year compared to last. In the US, recessions have in the past been preceded by an inverted yield curve (difference between short- and long-term yields), and current yield curve dynamics suggest that this is again probable. However, it remains to be seen whether the strength of the labour market and a strong private sector can help stave off a recession in the US.

Chart: Long-term US 2v10 yield curve vs US recession



Source: Bloomberg

As the new year progresses, the market is expected to remain sensitive to the interplay between monetary policy and economic growth

China reopening

While most economies are projected to slow this year, China is expected to buck the trend as the economy finally reopens. The shift toward reopening has been quicker than expected and there is a lot of uncertainty about how this will play out. A strong recovery could be a tailwind for global growth and commodity exporters like South Africa, however, at the same time this could stoke inflation and keep some pressure on central banks.

Higher long-term borrowing costs limit room for fiscal support

Tighter monetary policy has put significant upward pressure on long-term borrowing costs and has reduced policy space for governments to respond to slower growth, especially in developing and emerging economies. This will mean that countries with high levels of foreign-currency-denominated debt will remain under pressure, which will leave policymakers with less room to respond to any slowdown in growth.

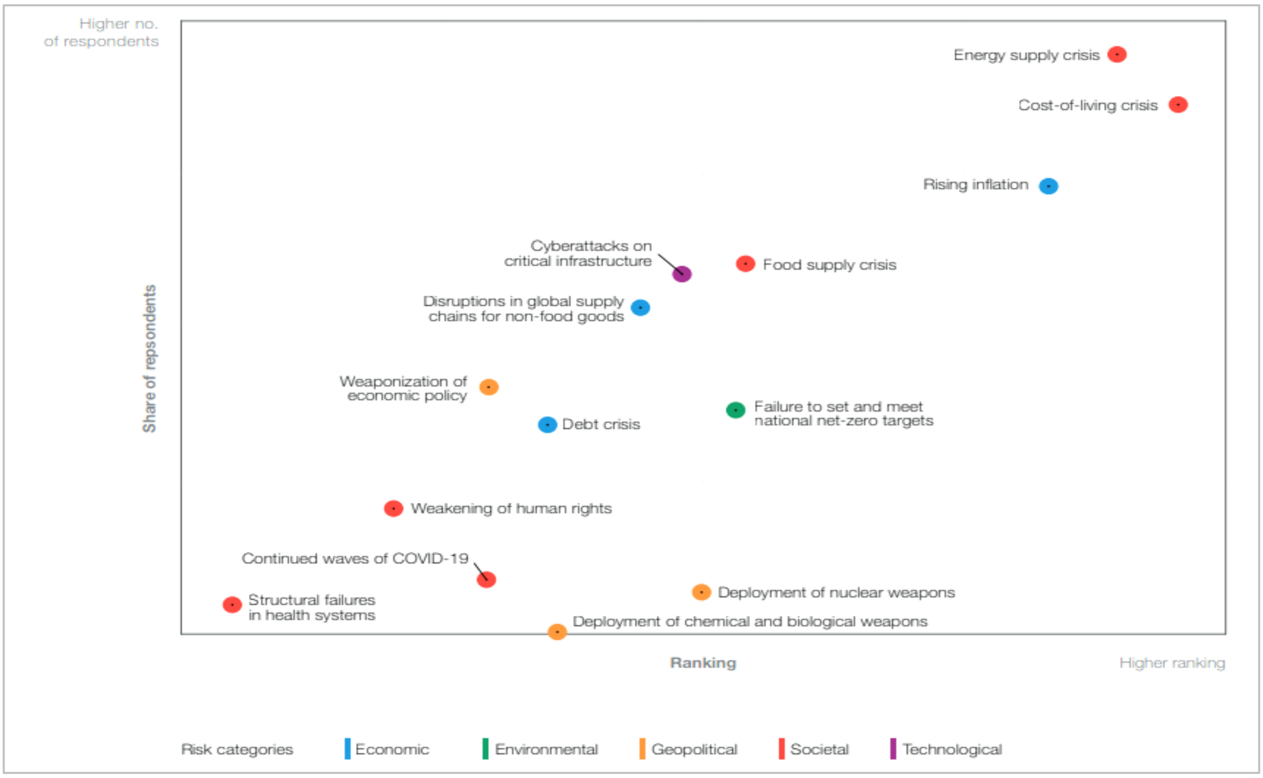
Geopolitical tensions remain elevated

Geopolitical risks remain heightened at the start of 2023 as the Russia–Ukraine war drags on. Other geopolitical risks stem from the superpower competition between the US and China, while the possibility of China invading Taiwan cannot be ruled out. The pandemic has had far-reaching implications for trade and financial systems, encouraging many countries to become more self-sufficient and creating global trade policy uncertainty. These dynamics continue to present downside risks to the global economy and markets in 2023.

Climate change, energy security and cost of living amongst top concerns in 2023

Weather events linked to climate change continue to have a detrimental impact across the globe. Aside from the devastating human costs of climate-related disasters, the disruption to economic activity and infrastructure presents downside risks to the global economy, and more attention is being given to addressing these issues through sustainable investment. While the Russia–Ukraine conflict has stifled efforts across the globe to move away from coal, the transition to clean energy is becoming a global imperative and energy security remains a top priority in 2023. According to the 2022–2023 Global Risk Perceptions Survey (GRPS) released by the World Economic Forum, the energy supply crisis, as well as rising inflation and the cost-of-living crisis are among the top concerns for this year, according to respondents.

Chart 10: Currently manifesting risks (respondents were asked "Please rank the top 5 currently manifesting risks in order of how severe you believe their impact will be on a global level in 2023")



Source: World Economic Forum Global Risks Perception Survey 2022–2023

Although the energy supply crisis remains a major concern, Europe's reliance on Russian supplies continues to shift and a milder than expected winter has helped to keep inventories well-stocked, relieving some pressure on gas prices at the start of 2023.

APPENDIX

Financial market performance as at 31 December 2022 (ZAR)

	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)	-2,3%	15,2%	3,6%	3,6%	12,7%	8,0%	8,9%	9,9%
FTSE/JSE Resources 20 Index	-3,6%	17,6%	6,2%	6,2%	19,4%	20,2%	20,9%	7,7%
FTSE/JSE Industrials Index	-0,3%	15,7%	-3,7%	-3,7%	10,9%	4,1%	4,9%	9,8%
FTSE/JSE Financials Index	-4,8%	12,9%	6,9%	6,9%	3,7%	0,5%	3,8%	7,4%
FTSE/JSE Shareholder Weighted Index (SWIX)	-2,7%	12,4%	3,6%	3,6%	8,8%	4,4%	6,6%	8,5%
FTSE/JSE Capped Swix Index (Capped SWIX)	-2,8%	12,2%	4,4%	4,4%	10,1%	4,9%	6,5%	8,3%
FTSE/JSE All-Share Top 40 Index	-2,3%	17,1%	4,2%	4,2%	13,7%	8,7%	9,1%	10,2%
FTSE/JSE SWIX Top 40 Index	-2,9%	14,0%	4,6%	4,6%	9,1%	4,4%	6,3%	8,5%
FTSE/JSE Mid Cap Index	-2,9%	8,0%	1,6%	1,6%	3,9%	3,2%	6,9%	7,1%
FTSE/JSE Small Cap Index	-1,4%	4,4%	7,6%	7,6%	19,5%	6,9%	8,2%	9,8%
FTSE/JSE Listed Property Index (SAPY)	1,1%	19,3%	0,5%	0,5%	-3,4%	-7,2%	-1,7%	2,8%
FTSE/JSE Capped Listed Property Index	1,1%	18,3%	-2,2%	-2,2%	-5,8%	-9,8%	-5,7%	0,9%
Local Interest-Bearing Indices								
FTSE/JSE All-Bond Index (ALBI)	0,6%	5,7%	4,3%	4,3%	7,1%	7,8%	9,2%	7,1%
FTSE/JSE All-Bond Index 1 - 3 years	0,7%	3,7%	5,7%	5,7%	7,1%	7,6%	8,2%	7,2%
FTSE/JSE All-Bond Index 3 - 7 years	0,6%	4,5%	5,3%	5,3%	7,9%	8,5%	9,6%	7,7%
FTSE/JSE All-Bond Index 7 - 12 years	1,1%	6,3%	4,7%	4,7%	7,4%	8,3%	9,7%	7,2%
FTSE/JSE All-Bond Index +12 years	0,3%	5,8%	3,7%	3,7%	6,9%	7,5%	9,2%	6,8%
Inflation Linked Government Bonds (IGOV)	2,7%	2,2%	4,2%	4,2%	7,8%	5,1%	4,9%	5,0%
Short-Term Fixed Interest Composite Index (SteFi)	0,5%	1,6%	5,2%	5,2%	4,8%	5,8%	6,3%	6,1%
Inflation Index								
Consumer Price Index (1 month lagged)	0,3%	0,8%	6,8%	7,4%	5,3%	4,9%	5,1%	5,2%
International Indices								
MSCI World Index	-3,8%	3,6%	-12,0%	-12,0%	12,6%	13,7%	10,6%	17,3%
MSCI Emerging Market Index	-1,0%	3,5%	-14,2%	-14,2%	4,3%	5,5%	7,0%	9,2%
FTSE World Government Bond Index (WGBI)	0,2%	-2,1%	-12,6%	-12,6%	0,7%	3,9%	0,8%	5,9%
S&P Global Property	-2,2%	1,3%	-18,1%	-18,1%	2,0%	6,5%	4,2%	11,2%
USA S&P 500	-5,4%	1,4%	-12,4%	-12,4%	15,0%	16,6%	13,0%	20,7%
UK FTSE 100	0,2%	11,4%	0,1%	0,1%	6,8%	7,6%	5,1%	10,7%
Euro STOXX 50	-0,2%	18,2%	-8,9%	-8,9%	7,9%	8,3%	5,9%	11,7%
Japan Nikkei 225	-0,2%	5,0%	-13,0%	-13,0%	5,6%	8,4%	6,8%	14,9%
Currency Movement								
Rand/Dollar (R17.04= 1 Dollar)	-1,0%	-5,8%	6,9%	6,9%	6,8%	6,6%	1,4%	7,2%
Rand/Euro (R18.24= 1 Euro)	1,9%	2,8%	0,6%	0,6%	5,1%	4,2%	1,2%	5,0%
JPY/Rand (7.7 Japanese Yen= 1 SA Rand)	-4,1%	-3,7%	6,8%	6,8%	-0,2%	-3,1%	-0,1%	-2,8%
Rand/Pound (R20.59= 1 Pound)	-0,7%	1,9%	-4,6%	-4,6%	3,5%	4,3%	-1,4%	4,1%

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