MENTENOVA

# ECONOMIC OVERVIEW

QUARTER 1, 2024

# Contents

# EXECUTIVE SUMMARY

The first quarter of 2024 has been marked by some pivotal shifts in global economic dynamics and evolving market sentiment, evidenced by changes in market consensus and diverse market performance, intertwined with the ever-present geopolitical risks. These factors have collectively influenced investment strategies and economic outlooks across regions, both in developed and emerging markets, and across different asset classes.

The beginning of 2024 saw a pivot in market consensus on rate cut outlooks, from a very optimistic one to a more guarded stance. Central banks (notably in the Eurozone, US and South Africa) played a key role in shaping this consensus, proceeding cautiously with rate adjustments while remaining mindful of ongoing price pressures and strong DM labour markets – despite global inflation declining from its 2022 peak. Strategic fiscal moves were made to reinforce inflation control and support economic growth. The US led in GDP growth, with South Africa and the Eurozone trailing their North American counterpart. As of early 2024, with inflation still a concern (especially in South Africa), central banks adopted a cautious approach, keeping interest rates steady.

Geopolitical risks have continued to loom over economies throughout the world, influencing market sentiment and capital flows. The ongoing tensions in Eastern Europe and the Asia-Pacific region have led to heightened risk aversion, which has been a catalyst in investors turning to safe-haven assets – with notably increased allocations to gold and the US dollar. In 2024, known as the year of elections, around 2 billion voters are expected to go to the polls. In Taiwan's recent election, Lai Ching-te from the Democratic Progressive Party (DPP) won, thus emphasising Taiwan's independence. However, it has triggered increased tensions with China, including military threats from the latter. Owing to concerns about potential conflicts and their impact on supply chains and energy markets in various regions, businesses are considering relocating to politically stable destinations like India, which would boost that country's foreign investments and equity market performance. This highlights the importance of portfolio diversification in sectors and regions that are less susceptible to geopolitical shocks.

The Japanese economy has shown moderate growth, supported by its export recovery and stronger domestic consumption. However, challenges remain, including aging demographic issues and public debt. On the bright side, Japan's negative rate cycle has come to an end, with the Bank of Japan raising interest rates for the first time in 17 years to a target range of 0% to 0.1%. Japan's commitment to technological innovation and strategic fiscal policies positions it well for gradual economic strengthening and economic policy stabilisation. However, the shift in the interest rate target caused an unexpected drop in the yen to a 34-year low against the US dollar. The move could, though, make Japanese government bonds attractive for investors seeking higher yields. Over the quarter, equities have done well, reaching record highs not seen since 1989. Drivers in this regard have been strong company earnings, the yen's depreciation, a robust global economy, undervaluation against other markets, and corporate governance improvements. Nevertheless, their future performance, amid potential yen strengthening and economic shifts, is the subject of debate.

Complexity surrounded emerging markets, with the key theme being differentiation. The growth exhibited was driven by global demand and commodity dependency. Despite the challenges presented by currency volatility and inflation, there have been opportunities for growth in the technology and energy sectors. This drove equity markets to 5.9% over the quarter, fuelled by China's unexpected economic activity and lower loan rates. Even with the differentiation in data across the markets, India's and Brazil's strong economies and stable politics attracted investors, while China and South Africa faced challenges.

Over the quarter, global equity markets, particularly the US S&P 500, have experienced heightened volatility, driven by various economic indicators. However, sectors such as energy (17.08% QTD) and information technology (12.69% QTD) have emerged as growth areas. In contrast, bond markets have reflected a rather cautious stance from investors, as driven by central banks. In their search for quality, investors have gravitated towards sovereign and high-grade corporate bonds. That said, a question that should be top of mind for investors is whether it is time to rotate from equities to bonds. Research conducted shows that US equities have outperformed US bonds during all rate hiking cycles since 1986. However, historically, following rate hiking cycles, US bonds have consistently yielded positive returns over the next year, while equity performance has been mixed. Given that eight months have elapsed since the last hike and considering the current economic backdrop of high inflation and a strong economy, the analysis suggests a cautious outlook for equities outperforming bonds, reinforced by a narrow yield spread and a high price-to-earnings ratio. Drawing on the 1994 and 2022 rate hike comparisons, there is short-term potential for equities to outperform bonds, prompting a critical decision as to whether to stick with US equities or pivot to bonds for potential profit-taking.

As we move beyond the first quarter of 2024, the global economy continues to present a tapestry of challenges and opportunities. The road ahead will undoubtedly require an understanding of geopolitical risks, a commitment to economic resilience, and a strategic approach to leveraging the growth potential of both developed and emerging markets. The dynamic interplay between market forces and economic policies will continue to shape the trajectory of global growth, with implications for investors, businesses and economies throughout the world.

# ECONOMIC AND MARKET OVERVIEW

## A Shift in Consensus

In Q4 2023, markets were buoyed by expectations of rate cuts taking place in early 2024, leading to rallies across risk assets and various sectors. Notably, the S&P 500 outperformed other equity markets, returning 11.7% for the quarter, followed by the JSE Capped SWIX at 8.2% and the STOXX 600 at 6.7%. Growth stocks surpassed value stocks, returning 13.3% compared to 9.2% for the quarter. The property sector emerged as a standout performer across multiple regions, supported by dovish outlooks on monetary policy decisions.

Central banks in the Eurozone, US and South Africa faced the challenge of timing their rate cuts carefully to mitigate possible adverse economic consequences. Despite global inflation's gradual decline since its 2022 peak, policymakers remained cautious due to recent price pressures, robust labour markets and productivity, and economic growth indicators, particularly in the US.

**Figure 1: Year-on-year inflation rates**

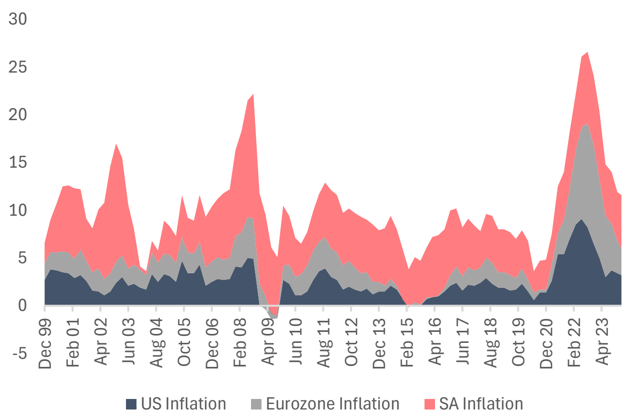
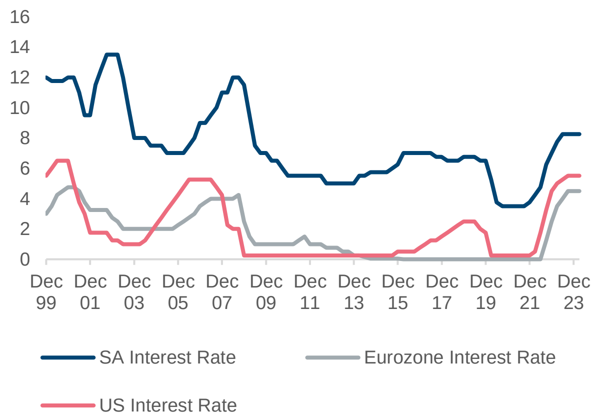



**Figure 2: Interest rates**




*Source: Bloomberg*

Labour markets in the US and the Eurozone showed their strength throughout 2023, maintaining low unemployment rates of 3.8% and 6.4%, respectively, into 2024. South Africa's labour market, marked by a significantly higher unemployment rate of 32.1%, remained relatively stable. The combination of tight monetary policy and fiscal support contributed to a stronger labour market in the Eurozone and US, while also causing an economic slowdown. Regionally, GDP growth rates for 2023 varied, with the US leading at 2.5%, followed by South Africa at 0.6% and the Eurozone at 0.4%. However, central banks aimed to complete the tightening cycle to bring inflation down to target levels without inducing a material recession.

As of February 2024, inflation rates varied across regions, with the US at 3.2%, the Eurozone at 2.8% and South Africa at 5.6%, indicating stickier inflation trends, particularly in South Africa. Consequently, major central banks, including the South African Reserve Bank (SARB), kept key interest rates steady in Q1 2024, signalling a cautious approach.

**Figure 3: Unemployment rates**

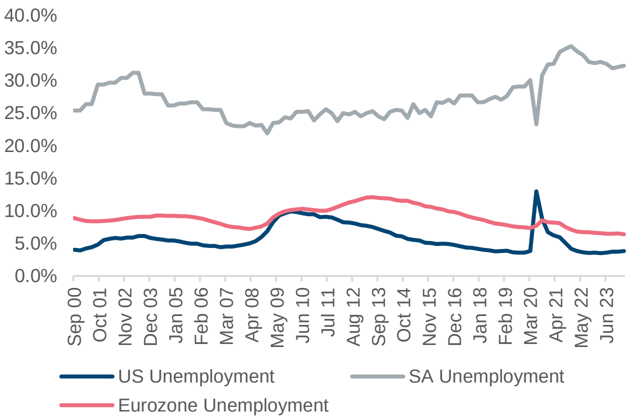
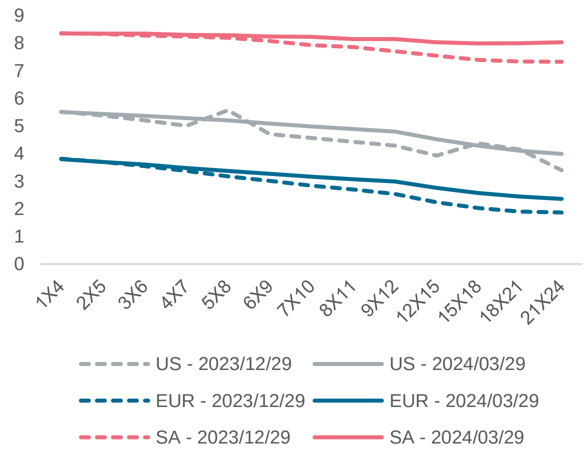



**Figure 4: Forward rate agreement rates**




*Source: Bloomberg*

These decisions reflect a collective expectation of possibly fewer or delayed rate cuts among central banks. The prevailing macroeconomic trends have been shaped by this delicate balance between monetary tightening and fiscal support across the Eurozone, US and South Africa. Year-to-date rate cut expectations have presented an even more conservative view, evidenced by SA and US forward rate agreements, in the wake of the latest central bank communications and economic data released over the quarter.

Market volatility ensued in the first quarter 2024 due to changes in rate cut expectations, with fixed income and local equities bearing the brunt. Despite this, some indices, such as the S&P 500 and NASDAQ, rallied to new record highs in February.

Looking ahead, uncertainties will persist in 2024 regarding the future trajectory of monetary policy and the resilience of the job market. While most countries narrowly avoided technical recessions in Q4 2023, challenges faced by sectors such as domestic agriculture from the El Niño effect and from geopolitical risks will continue to linger in 2024. Moreover, a slew of upcoming elections and policy reforms bring additional layers of complexity to the global economic landscape in 2024.

# Geopolitical Forces: Shaping Capital Market Flows

## A peek into global elections and their impact on global trade

The global elections are a significant focus area this year, with approximately 2 billion people expected to cast their votes. The elections have already taken place in some countries, with varying degrees of controversy. One of the most notable was the Taiwanese election on 13 January, which saw a victory for Lai Ching-te of the Democratic Progressive Party (DPP). This heralds the third consecutive term for the DPP, a party that advocates Taiwan's sovereignty and independence from China. The opposition parties, the Kuomintang (KMT) and Taiwan People's Party (TPP), favour closer engagement with Beijing.

In response to the DPP's victory, China has reduced its diplomatic allies in Taiwan and increased military threats, while sending warplanes into Taiwanese airspace. This has raised concerns about China's intentions towards Taiwan, with a few experts suggesting that China may be prepared to invade Taiwan and bring it under Chinese rule. Such a scenario could lead to a war between China and the US, given the US's commitment to defend Taiwan. This would have significant consequences for global economic activity and growth, as trade between the two nations is substantial.

## How the AI race is increasing tensions in certain regions and creating a wave of opportunity in others

The information technology sector is a significant contributor to the US economy. As the world starts to shift its attention increasingly towards the use of artificial intelligence (AI), the sector's prospects of success are heavily dependent on semiconductor production. Taiwan has become a manufacturing hub for many businesses producing semiconductors, with the US opposing China's significant control over this industry. To mitigate the risk of disruptions to semiconductor production, businesses have considered moving part of their manufacturing operations to India, which has a more stable political environment. This has also resulted in India attracting more foreign direct investment, as developed countries look for an emerging market player to back during this time of uncertainty.

**Figure 5: Monthly gold price over time**

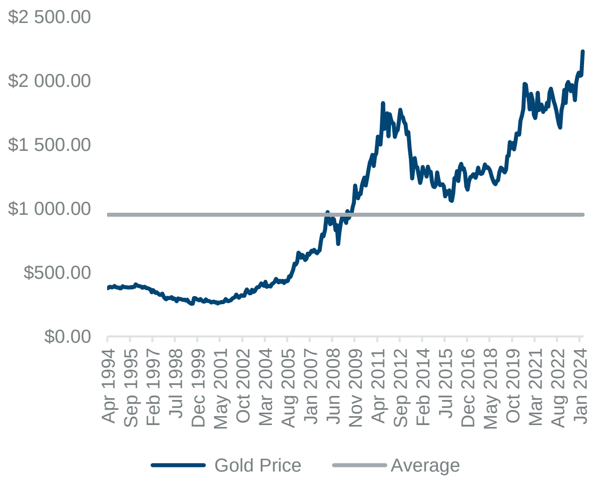
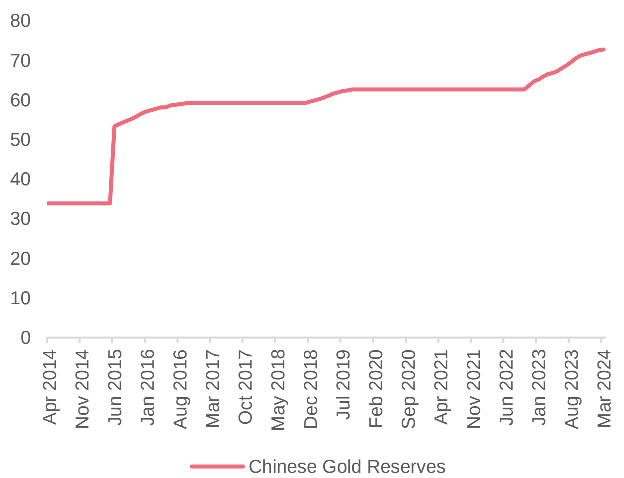



**Figure 6: Chinese gold reserves in troy ounce millions**




*Source: Bloomberg*

The NIFTY 50, a benchmark Indian stock market index showing the weighted average of the largest 50 Indian companies listed on the National Stock Exchange, has done well over the last quarter, outperforming its emerging market peers. Foreign direct investment has continued to flow from China to other countries, such as Japan and Brazil. Meanwhile, China's public and private sectors have imported a significant amount of gold, leading to a significant increase in the gold price – greater than historical levels – which is still climbing. The price closed at $2,229.87 per ounce at the end of the quarter, representing an 8.1% increase from the beginning of the year. China also reduced US treasury holdings by $529bn in January 2024 from the peak in November 2013, i.e., from c.11% of total outstanding US treasuries to c.3%.

## China's foreign exchange reserves management and geopolitical impact

China has moreover reduced its US dollar reserves; a step also taken by Singapore. This is a strategy to reduce exposure to US dollar trade, which can be seized by the US in the event of sanctions being imposed on certain regions. The wars occurring around the world, such as Russia–Ukraine and Hamas–Israel, have created immense geopolitical uncertainty. Gold benefits from its status as a safe haven asset, with its price increasing in the face of geopolitical uncertainties and high interest rates and supply chain disruptions caused by Houthi rebels attacking cargo and energy ships transporting goods from the Middle East and Asia to Europe.

The UN has put out repeated calls for a ceasefire in the Israeli conflict, which have fallen on deaf ears. The Houthi rebels have vowed to continue their attacks until Israel has ceased its military operation in Gaza. The attacks on cargo ships have led to ships taking detours from this regular route, increasing the cost of shipping and potentially affecting global inflation.

# Underappreciated Assets: China and South Africa

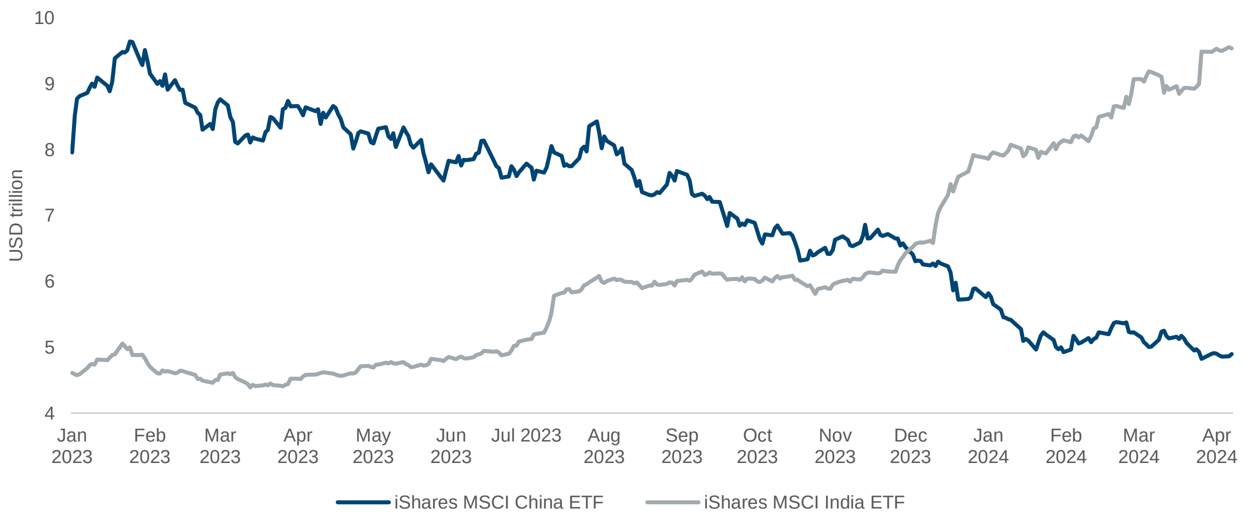
Emerging market equities declined at the beginning of the quarter, returning -2.5%. China's ongoing economic downturn and concerns about the Fed's decision to hold rates steady for longer contributed to the negative sentiment. However, emerging markets have seen gains over the quarter, returning 5.9%, and ended on a positive note. The recovery from China has positively impacted performance, prompted by better-than-expected economic activity data and a reduction in the five-year loan prime rate. Furthermore, the surge in emerging market equities has been supported by strong demand for semiconductors and investor enthusiasm for artificial intelligence (AI) and technology equities.

Emerging markets have been producing mixed data, with the BRICS nations, particularly Brazil, China, India and South Africa being the focus of discussion. India and Brazil have received a nod from investors due to their strong economies and stable political landscapes. However, China, which was previously a drawcard for investors pre-Covid, has been struggling to win investors' hearts and money. The same can be said about South Africa. The two countries' economic downturn has been a focal point, with negative sentiment being the order of the day. Do they deserve such a sentiment, or do they present some investment opportunities? Before we examine these two markets in more detail, let us quickly review the new darling of global investors: India.

## India: New flavour of the month and investor favourite

Over the past 20 years, India's economy has grown very rapidly relative to other emerging markets, averaging 6.8% growth annually. Despite India suffering large economic losses during the Covid-19 pandemic, it has made a good recovery since then. Indian stocks have rallied in response to general confidence regarding the nation's growth, while its PMI has been expanding and remained above the 55-point mark throughout 2023 and into the first quarter of 2024. This is in stark contrast to the ongoing concerns among global investors about investing in China's financial assets as risks and sentiment drag. Thus prompting the withdrawal of billions from China's struggling economy. Currently, most of these capital withdrawals are going to India. India briefly overtook Hong Kong recently as the world's fourth-largest equity market. The graph below provides insights into the two MSCI ETF fund sizes, which reflect the total money invested in each of the iShares MSCI ETFs.

**Figure 7: iShares MSCI China and India ETF total assets size**



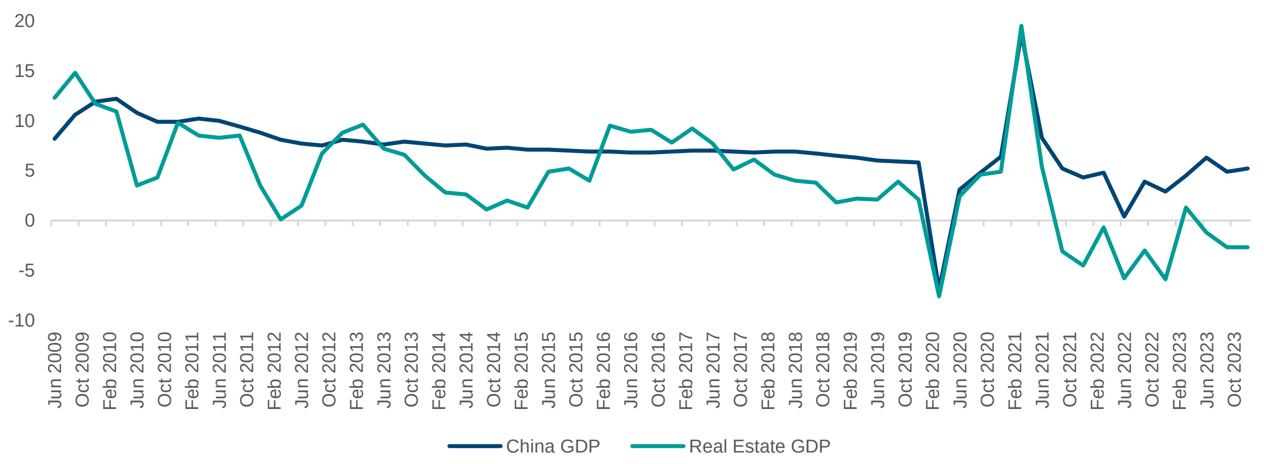

*Source: Bloomberg*

## China and South Africa: To be or not to be investable?

So, the key question is: do China and South Africa, at current valuations, present attractive investment opportunities in terms of an EM basket?

The real estate industry has dominated China's economic downturn, casting doubt on investors' assessments of the country's economic health. China's lack of data and policy transparency has not helped matters either. In contrast, China's purchasing manager index (PMI) has surpassed the 50 neutral mark in the first quarter of 2024, while the country's business activity and new orders from domestic and foreign buyers show that market sentiment in the country is generally optimistic. In addition, inflation turned positive after months of deflation. This better-than-expected economic data can largely be attributed to the recent Lunar New Year holiday which drove up the food and services CPI. Furthermore, the People's Bank of China (PBoC) announced the largest cut to the five-year loan prime rate (LPR) since 2019, from 4.2% to 3.95%. The move by PBoC forms part of a series of policies announced in 2023 to restore consumer confidence and avoid a potential property market collapse. Contrary to market perceptions, China's GDP has been resilient, except in the case of the real estate sector which has been declining over the past few years. Certain industries, such as electric cars, renewable energy and semiconductors, have seen high levels of capital spending.

**Figure 8: China GDP vs real estate GDP growth YoY%**




*Source: Bloomberg*

The local bond market in South Africa has attracted divided sentiment. Some investors are still enthusiastic, despite the possibility of yields remaining high and fears about inflation, while others are more cautious. Foreign investors have been selling their South African bonds recently in the face of the upcoming election which poses a major looming risk, particularly if the results dictate the formation of unfavourable coalitions. Many of the bond selloffs in South Africa or other emerging markets have been directed at US fixed income. In addition, emerging markets such as Brazil seem to offer better real yields and S&P credit ratings, with a better macroeconomic landscape and less political uncertainty. There appears to be limited offshore demand for South African government debt. This may not change, given higher US real yields, emerging market currency volatility, looming election risk and other longstanding structural issues that weigh heavily on the country's growth prospects. However, South African government bonds do provide better income at the current yield level than cash. South Africa's equity market has been trading at one of the lowest P/B (price to book) levels to date, at 1.5x as of the end of March 2024, which is much lower than its historical 2.1x. This reflects the excessive pessimism in current share prices and valuations. Fortunately, investor pessimism over slow growth, relatively high inflation, worsening government debt metrics, political instability, and so on, has been priced in.

Despite India being an investor favourite, evidenced by large inflows and an ongoing positive growth trajectory, Indian equities are much more expensive. SA equities' ROE is better than its 10-year average – not far from that offered by Indian equities but with a much cheaper valuation. Chinese equities seem to be less attractive than SA equities since their cheapness comes with worse fundamentals. Thus, there are still opportunities in South Africa and, to a lesser extent, China, for investors to take advantage of the cheap valuations. In contrast, the Chinese government has made numerous attempts to boost business confidence, although recent business-friendly policy changes have mostly been viewed as short-term fixes to deal with the country's growth slump. Furthermore, recent policy moves to allow local governments to boost regional property demand, the PBoC's outsized mortgage interest rate cut, and evidence of the first buds of recovery in household confidence could mark the end of the three-year housing contraction. However, until there are signs of improved policy certainty and renewed business and investor confidence, global investors should view China as a good tactical candidate from time to time rather than a destination for long-term investments.

**Figure 9: PE and ROE ratios for Brazil, India, China and South Africa**

| | Brazil | India | China | South Africa |
|---|---|---|---|---|
| **P/E Ratio** | 9.47x | 23.11x | 13.92x | 15.12x |
| **10-Year Avg P/E Ratio** | 14.93x | 23.19x | 15.29x | 16.63x |
| **ROE Ratio** | 15.60% | 15.83% | 9.11% | 13.34% |
| **10-Year Avg ROE** | 11.13% | 13.89% | 10.50% | 11.89% |

*Source: Bloomberg*

# Turning the Tide: Japan's Q1 2024 Economic Reformation and its Global Implications

## Japan's monetary pivot: From negative rates to new horizons in Q1 2024

In the first quarter of 2024, the Bank of Japan (BOJ) introduced a pivotal change in its monetary policy by concluding its extended period of negative interest rates and by dismantling its Yield Curve Control (YCC) framework. This was a significant move, marking the nation's first interest rate increase in 17 years, to a target range of between 0% and 0.1%, and a transition towards the normalisation of Japan's economic policy environment. The departure from the longstanding negative interest rates and YCC has been heralded as a crucial step towards the creation of a more conventional economic environment within the country.

The repercussions of this policy adjustment have been plentiful. Contrary to what economic theories might predict, the yen experienced a notable weakening in the aftermath of the BOJ's decision, plummeting to a 34-year low of around 150.73 to the US dollar during March 2024. This significant depreciation of the yen was largely ascribed to the monetary policy divergence between Japan and the US and a general dissatisfaction in the market with what was perceived as a lack of decisive action from the BOJ in its policy shift.

## Diversification into Japanese bonds

With the BOJ’s policy shift, Japanese government bonds (JGBs) may become more attractive due to potentially higher yields. Investors could consider diversifying their fixed-income portfolios by including JGBs, especially if the yield differential with other major economies narrows. Some analysts note that the BOJ's policy shift could usher in a period of normalisation for Japanese bond markets, attracting investors at higher yields. Despite the potential for higher yields in Japan, the Council on Foreign Relations notes that Japanese fixed income flows reflect the incentives created by the JGB curve and global yield differentials. Even with changes in BOJ policy, short-term and long-term Japanese rates will likely remain well below those in the US and Europe, suggesting that Japanese investors may continue to be net buyers of foreign bonds.

## Yen: currency of choice for carry trades

The yen carry trade, a strategy of leveraging Japan’s historically low and negative interest rates to profit from the interest rate differential between Japan and other countries, faces a potential shift in the wake of the BOJ’s recent policy changes. These changes, including the ending of Yield Curve Control (YCC) and negative interest rates, will lead to higher yields from Japanese government bonds (JGBs). This then will diminish the appeal of Japanese investors (who, according to Commerzbank, have an estimated $2 trillion in overseas investments) seeking higher yields overseas.

In contrast, Samurai bonds, which are yen-denominated bonds issued in Japan by foreign entities, have made it possible for international issuers to access the Japanese capital market at lower borrowing costs, thanks to the low-interest rate environment. The BOJ's policy shifts increase the cost of issuing Samurai bonds for foreign entities, while potentially making these bonds less appealing to international investors if the yen strengthens.

**Figure 10: Interest rate differential between US and Japan**

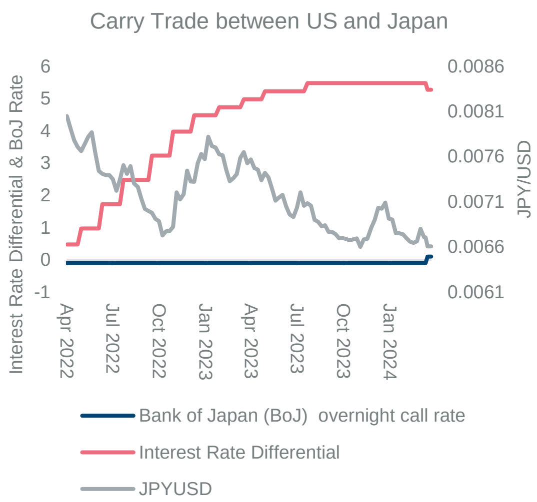



**Figure 11: Winners and losers as BOJ hikes rates**

**Rising Rates in Japan**

| Winners | Channel | Losers | Channel |
|---|---|---|---|
| Megabanks | Higher interest rates | Government | Higher interest rates |
| Regional banks | Higher interest rates | Bank of Japan | Losses on bonds |
| Importers | Stronger yen | Regional banks | Losses on bonds |
| Power-intensive firms | Stronger yen | Global Firms, Exporters | Stronger yen |
| Life insurers | Higher interest rates | Real-estate firms, property owners | Cooler property market |
| Investment Banks | Higher interest rates | Zombie firms | Higher interest rates |
| Wealth managers | Higher interest rates | Mortgage holders, renters | Higher rates, rents |
| Consumers | Stronger yen | Bondholders | Losses on bonds |
| Foreign holders of Japan stocks | Stronger yen | Japanese holders of foreign stocks | Stronger yen |
| Bank deposit holders | Higher interest rates | Households with consumer loans | Higher interest rates |
| Japanese tourists abroad | Stronger yen | Inbound tourists, hospitality sector | Stronger yen |

Bloomberg

*Source: Bloomberg*

## Nikkei's historic rise in Q1 2024: Decoding Japan's equity market boom

The Nikkei 225 Stock Index delivered a remarkable performance in the first quarter of 2024, achieving all-time highs that had not been observed since 1989. This surge was propelled by a confluence of factors. A noteworthy improvement in the earnings of Japanese companies, as evidenced by an 8.3% growth in earnings per share (EPS) for the MSCI Japan Index in 2023 (despite the economic slowdown), underscored the resilience and potential of the Japanese market. The depreciation of the yen during this period played a pivotal role in enhancing the profitability of Japanese exporters, thereby boosting investor confidence in the Japanese equity market.

Additionally, a robust global economic climate contributed to a generally positive sentiment towards equities worldwide, including those in the Japanese stock market. The relative undervaluation of Japanese stocks attracted high levels of foreign investment, buoyed further by ongoing efforts to improve corporate governance in Japan. These governance reforms, aimed at increasing transparency and shareholder rights, have also been instrumental in the Nikkei's ascendance.

As of 29 March 2024, the MSCI Japan P/E ratio was 17.9x, lower than the MSCI World at 21.6x and MSCI USA at 25.7x. This suggests that the Japanese market might be relatively undervalued compared to other major indexes, such as the S&P 500. Despite the exceptional rally, analysts have mixed views about the sustainability of this performance, with some expressing concerns over potential market corrections in response to the potential surrounding the yen's surprise strengthening and shifts in global economic conditions.

# Sustaining US Equities Momentum or Time to Rotate into Bonds?

## Navigating the shift and unlocking potential

The S&P 500 has consistently outperformed US treasuries during all rate hiking cycles since 1986. Over the entire period analysed, there were only two instances where US equities underperformed US treasuries: in 1972 and 1983.

**Figure 12: S&P 500 and US treasury performance during past rate hiking cycles**

| First Fed Rate Hike | Fed Funds Rate Above Equilibrium | Recession | Rate Hike (BPs) | Months of Hiking | First Hike to Recession | Above Equilibrium to Recession | S&P 500 Total Return* in USD (during the hike) | Bloomberg US Treasury Total Return** in USD (during the hike) | S&P 500 vs US Treasury (during the hike) |
|---|---|---|---|---|---|---|---|---|---|
| Mar-72 | Jun-73 | Nov-73 | 400 | 28 | 21 | 7 | -19.3% | 6.5% | -25.8% |
| Aug-77 | Sep-79 | Jan-80 | 1175 | 32 | 29 | 4 | 3.3% | 3.3% | -0.1% |
| Oct-80 | Oct-80 | Jul-81 | 650 | 8 | 9 | 12 | 5.7% | 3.5% | 2.2% |
| Mar-83 | Jul-83 | | 294 | 17 | | | 1.0% | 9.6% | -8.6% |
| Dec-86 | May-88 | Jul-90 | 394 | 30 | 44 | 26 | 35.3% | 15.5% | 19.8% |
| Feb-94 | Nov-94 | | 300 | 13 | | | 4.4% | -0.9% | 5.3% |
| Aug-99 | Nov-99 | Mar-01 | 150 | 10 | 19 | 16 | 8.0% | 3.6% | 4.4% |
| Jun-04 | Dec-05 | Dec-07 | 425 | 25 | 43 | 24 | 17.7% | 5.7% | 12.1% |
| Dec-15 | | Feb-20 | 225 | 37 | 51 | | 28.4% | 4.1% | 24.3% |
| Mar-22 | Dec-22 | | 550 | 17 | | | 7.4% | -9.1% | 16.5% |

*S&P 500 Price Return prior to 1988

**US treasury monthly returns for the period from Jan 1972 to Jan 1973 sourced from McCulloch

*Source: Bloomberg, BCA Research*

An examination of the data following the last rate hikes reveals a consistent trend: US treasury has reliably shown positive returns over a one-year forward horizon. However, the performance of the S&P 500 has varied. Notably, after the 1980, 1983 and 1999 rate hiking cycles, the S&P 500 significantly underperformed against the US treasuries, as shown in Figure 13.

**Takeaway 1:** When the S&P 500 begins its forward-looking period with an expensive valuation over bonds (negative earnings yield spread over treasuries), it tends to display a substantial underperformance following the ending of rate hiking cycles, and vice versa. *Interestingly, in 1994, despite an elevated PE ratio of 16.6x and premiums over bonds, the S&P 500 yielded an impressive 1-year forward return exceeding 20%.*

**Figure 13: S&P 500 and US treasury performance 1 year after the last rate hikes**

| First Fed Rate Hike | Fed Funds Rate Above Equilibrium | Recession | S&P 500 PE when rate hike ends | S&P 500 earnings yield vs US 10 year treasury spread when rate hike ends | S&P 500 Total Return* in USD (1 year post the hike) | Bloomberg US Treasury Total Return** in USD (1 year post the hike) | S&P 500 vs US Treasury (1 year post the hike) |
|---|---|---|---|---|---|---|---|
| Mar-72 | Jun-73 | Nov-73 | 9.86 | 2.2% | 10.7% | 10.6% | 0.1% |
| Aug-77 | Sep-79 | Jan-80 | 6.96 | 3.6% | 33.2% | 13.1% | 20.1% |
| Oct-80 | Oct-80 | Jul-81 | 9.05 | -2.8% | -15.6% | 15.2% | -30.8% |
| Mar-83 | Jul-83 | | 10.14 | -1.9% | 9.6% | 20.6% | -11.0% |
| Dec-86 | May-88 | Jul-90 | 13.07 | -0.4% | 16.6% | 8.7% | 7.9% |
| Feb-94 | Nov-94 | | 16.61 | -1.2% | 34.7% | 12.1% | 22.6% |
| Aug-99 | Nov-99 | Mar-01 | 26.70 | -2.3% | -10.6% | 11.1% | -21.6% |
| Jun-04 | Dec-05 | Dec-07 | 16.43 | 1.1% | 20.6% | 5.5% | 15.1% |
| Dec-15 | | Feb-20 | 18.06 | 2.9% | 31.5% | 6.9% | 24.6% |
| Mar-22 | Dec-22 | | 22.10 | 0.4% | 15.7% | 1.8% | 13.9% |

*S&P 500 Price Return prior to 1988

**US teasury monthly returns for the period from Jan 1972 to Jan 1973 sourced from McCulloch

***Rate hiking cycle for 2022, forward returns is 8 months for the period from Aug 2023 to Mar 2024

*Source: Bloomberg, BCA Research*

Given that it has been eight months since the last rate hike by the Fed, which likely marks the culmination of this rate hiking cycle, historical data suggests that the S&P 500 would not be expected to outperform US treasuries by such a significant margin. This is particularly evident, considering the starting price-to-earnings ratio (PE) of 22x for the S&P 500 and a spread of only 4 basis points (bps) versus the US 10-year treasury yield, which is well below the long-term average of 100 bps. However, it is also understandable that, given the backdrop of sticky inflation and a resilient US economy, regardless of the rate cut expectations, it is indeed a more constructive environment for equities than bonds.

Drawing parallels with the 2022 rate hiking cycle, it bears resemblance to the conditions observed in 1994 – no recession was triggered, albeit with slightly better economic performance, but there was also a higher valuation. If indeed this comparison holds true, it suggests that US equities may outperform US treasuries over the next 3 to 6 months. Consequently, the pivotal investment question is: is it opportune to continue favouring US equities over US bonds or to rotate from US equities into US bonds to take some profits?

**Figure 14: More on the economic fundamentals**

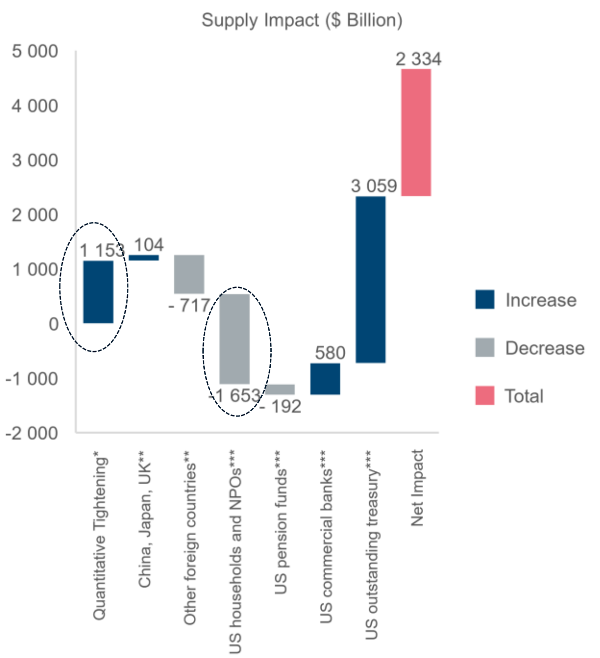
| First Fed Rate Hike | Fed Funds Rate Above Equilibrium | Recession | S&P 500 PE when rate hike ends | S&P 500 earnings yield vs US 10 year treasury spread when rate hike ends | US GDP QoQ Annualised (at the time) | US GDP QoQ Annualised (average next 12 months) | US inflation YoY (at the time) | US unemployment rate (at the time) | S&P 500 vs US Treasury (1 year post the hike) |
|---|---|---|---|---|---|---|---|---|---|
| Mar-72 | Jun-73 | Nov-73 | 9.86 | 2.2% | 1.1% | -1.9% | 11.5% | 5.5% | 0.1% |
| Aug-77 | Sep-79 | Jan-80 | 6.96 | 3.6% | 1.3% | 1.3% | 14.7% | 6.9% | 20.1% |
| Oct-80 | Oct-80 | Jul-81 | 9.05 | -2.8% | -2.9% | -1.9% | 9.6% | 7.5% | -30.8% |
| Mar-83 | Jul-83 | | 10.14 | -1.9% | 4.0% | 4.1% | 4.3% | 7.4% | -11.0% |
| Dec-86 | May-88 | Jul-90 | 13.07 | -0.4% | 3.2% | 2.8% | 5.2% | 5.3% | 7.9% |
| Feb-94 | Nov-94 | | 16.61 | -1.2% | 1.4% | 2.4% | 2.9% | 5.4% | 22.6% |
| Aug-99 | Nov-99 | Mar-01 | 26.70 | -2.3% | 7.8% | 1.9% | 3.7% | 4.0% | -21.6% |
| Jun-04 | Dec-05 | Dec-07 | 16.43 | 1.1% | 1.2% | 1.6% | 4.1% | 4.7% | 15.1% |
| Dec-15 | | Feb-20 | 18.06 | 2.9% | 0.6% | 3.0% | 1.6% | 4.0% | 24.6% |
| Mar-22 | Dec-22 | | 22.10 | 0.4% | 2.1% | 4.0% | 3.7% | 3.8% | 13.9% |

*S&P 500 Price Return prior to 1988
**US Treasury monthly returns for the period from Jan 1972 to Jan 1973 sourced from McCulloch
***Rate hiking cycle for 2022, forward returns is 8 months for the period from Aug 2023 to Mar 2024
Note: the latest PE ratio for the S&P 500 is hovering around 25x and the earnings yield spread versus the US 10-year Treasury yield has dipped to -2 basis points.
*Source: Bloomberg, BCA Research*

On the economic growth side, the median real GDP growth forecast by the FOMC has been revised upwards during the March 2024 meeting. Meanwhile, interest rate guidance remained at 4.6% for this year, suggesting 90bps cuts, as shown in Figure 15. From the supply side, taking into account the increase in outstanding US treasuries, quantitative tightening by the Fed, and changes in holdings of US treasuries by foreign countries and US households and other financial institutions, the overall net impact is a roughly $2 trillion increase in net supply of US treasuries that entered the broader market. This is since the implementation of QT where the impact thereof has been largely offset by increased US household holdings of US treasuries, as summarised in Figure 16.

**Figure 15: Federal Open Market Committee (FOMC) meeting projections**


**Figure 16: Net supply increase of US treasuries for the period from Q2 2022 to date**

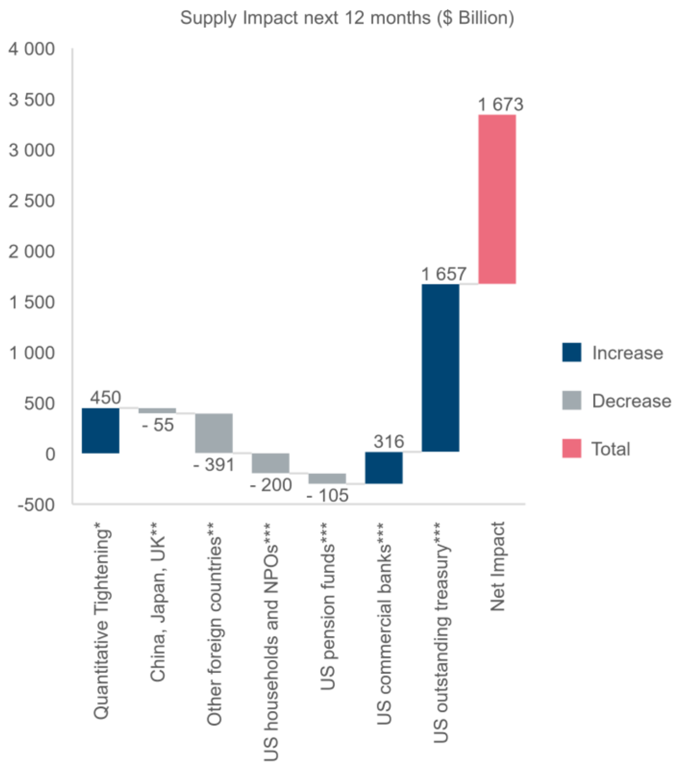



Note US commercial banks holdings include agency securities, figures exclude overseas custody accounts
*Jun 2022 to Mar 2024 **June 2022 to Jan 2024 ***Q2 2022 to Q4 2023
*Source: Federal Reserve, St Louis Fed, Bloomberg, US Treasury, Securities Industry and Financial Markets Association*

We expect some improvements but not a material drop in net US treasury issuance, for the following reasons (please refer to the latest Congressional Budget Office (CBO) budget and economic outlook for more details):

- Tax receipts to improve as capital gains were negatively impacted by limited transactions and the extension of some tax payment deadlines.
- Rising net interest costs as the CBO expects nearly two thirds of total deficit due to net interest outlays and the remaining primary deficit over the next decade.
- Most spending that is mandatory, together with net interest payments, is expected to increase from 72% of annual spending in 2023 to 74% by 2025, with limited room for expenditure cuts.
- The CBO expects the US debt-to-GDP ratio to increase from 97.3% in 2023 to 99% in 2024 and 101.7% in 2025 respectively, and to 116% by 2034.
- The CBO forecasted on average the $2 trillion net borrowings per year for the next decade, but there will be a short-term recovery for 2024, when $1.7 trillion is expected to be borrowed.
- Data from 1990 shows that the rolling 1-year changes in treasury holdings by US households is negatively correlated (-0.15) with the US unemployment rate, which means that a slowdown in the labour market would generally lead to lower holdings of US treasuries by US households.
- If we exclude 2020, the average rolling 12-month changes in US treasury holdings held by US households over the past 10 years have been around $200bn.

**Figure 17: Potential net supply increase of US treasuries for the next 12 months**




Key assumptions: assuming QT continues for $50bn (US treasury) for next 6 months and tapering to $25bn subsequently.
China and Japan holdings of US treasury to stabilise at current yield level; US household holdings of US treasury to increase by $200bn, using CBO estimates for US debt; current trends to continue for holdings by other factors.
*Source: CBO*

This suggests that we are likely to see $1 trillion to $1.5 trillion of net supply of US treasury into the broader market over the next 12 months.

**Takeaway 2:** Rate cut expectations should continue to drive the direction of the US treasury yields in the short term. Yet the increasing debt situation will put upward pressure on interest rates. The CBO expects the average interest rate on debt to be 3.5% over the medium to long term.

In conclusion, given the historical data, current economic dynamics and the supply issue overhang in the long run, it seems more likely for US equities to outperform US bonds over the short term but US bonds does generate decent income if one looks for some diversification should interest rates stay higher for longer.

# APPENDIX

## Financial market performance as at 31 March 2024 (in ZAR)

| JSE Code | | 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** | | | | | | | | |
| J203T | FTSE/JSE All-Share Index (ALSI) | 3.2% | -2.2% | -2.2% | 1.5% | 8.1% | 9.7% | 9.0% | 8.1% |
| J210T | FTSE/JSE Resources 20 Index | 15.4% | 0.8% | 0.8% | -10.7% | 0.3% | 9.4% | 13.7% | 4.7% |
| J257T | FTSE/JSE Industrials Index | 2.6% | 0.6% | 0.6% | 3.3% | 8.2% | 10.2% | 7.4% | 8.2% |
| J580T | FTSE/JSE Financials Index | -3.0% | -6.1% | -6.1% | 13.0% | 14.7% | 4.9% | 5.0% | 6.2% |
| J403T | FTSE/JSE Shareholder Weighted Index (SWIX) | 2.9% | -2.2% | -2.2% | 2.7% | 5.3% | 7.0% | 6.3% | 6.6% |
| J433T | FTSE/JSE Capped Swix Index (Capped SWIX) | 2.9% | -2.3% | -2.3% | 2.9% | 7.5% | 7.6% | 6.2% | 6.4% |
| J200T | FTSE/JSE All-Share Top 40 Index | 3.8% | -2.3% | -2.3% | 0.3% | 8.0% | 10.2% | 9.7% | 8.2% |
| J400T | FTSE/JSE SWIX Top 40 Index | 3.4% | -2.2% | -2.2% | 1.4% | 4.4% | 6.9% | 6.6% | 6.3% |
| J201T | FTSE/JSE Mid Cap Index | 2.3% | -3.5% | -3.5% | 6.8% | 8.2% | 5.9% | 4.0% | 6.2% |
| J202T | FTSE/JSE Small Cap Index | -0.7% | -1.1% | -1.1% | 9.1% | 15.8% | 13.3% | 6.1% | 7.8% |
| J253T | FTSE/JSE Listed Property Index (SAPY) | -1.0% | 3.8% | 3.8% | 20.5% | 13.9% | 0.7% | -1.4% | 3.1% |
| J254T | FTSE/JSE Capped Listed Property Index | -0.6% | 3.5% | 3.5% | 20.3% | 12.6% | -1.6% | -3.5% | 0.8% |
| | **Local Interest-Bearing Indices** | | | | | | | | |
| ALBI | FTSE/JSE All-Bond Index (ALBI) | -1.9% | -1.8% | -1.8% | 4.2% | 7.4% | 7.0% | 7.8% | 7.7% |
| ALBI01 | FTSE/JSE All-Bond Index 1 - 3 years | 0.1% | 0.8% | 0.8% | 7.5% | 6.7% | 7.4% | 7.8% | 7.7% |
| ALBI02 | FTSE/JSE All-Bond Index 3 - 7 years | -1.4% | -1.4% | -1.4% | 5.2% | 6.1% | 8.0% | 8.4% | 8.5% |
| ALBI03 | FTSE/JSE All-Bond Index 7 - 12 years | -2.3% | -2.4% | -2.4% | 4.6% | 7.8% | 7.9% | 8.4% | 8.2% |
| ALBI04 | FTSE/JSE All-Bond Index +12 years | -2.8% | -2.7% | -2.7% | 1.8% | 7.5% | 6.0% | 7.1% | 7.1% |
| IGOV | Inflation Linked Government Bonds (IGOV) | 0.2% | -0.5% | -0.5% | 5.6% | 7.0% | 6.3% | 5.0% | 5.4% |
| STFIND | Short-Term Fixed Interest Composite Index (SteFi) | 0.6% | 2.0% | 2.0% | 8.3% | 6.1% | 6.0% | 6.4% | 6.5% |
| | **Inflation Index** | | | | | | | | |
| ECPI | Consumer Price Index (1 month lagged) | 1.0% | 1.1% | 1.1% | 5.6% | 6.1% | 5.2% | 4.8% | 5.1% |
| | **International Indices** | | | | | | | | |
| MSCI.WRLD$ | MSCI World Index | 1.5% | 12.7% | 12.7% | 33.9% | 18.5% | 18.9% | 17.3% | 16.6% |
| MSCI.EM$ | MSCI Emerging Market Index | 0.8% | 5.9% | 5.9% | 15.6% | 3.5% | 8.3% | 9.3% | 9.6% |
| WGBI | FTSE World Government Bond Index (WGBI) | -1.3% | 0.9% | 0.9% | 5.6% | 1.9% | 3.2% | 4.3% | 5.2% |
| SPBMGPTU Index | S&P Global Property | 1.5% | 2.9% | 2.9% | 16.6% | 7.8% | 6.1% | 8.1% | 10.2% |
| FSPI | USA S&P 500 | 1.7% | 14.6% | 14.6% | 38.7% | 21.1% | 21.5% | 19.9% | 19.8% |
| FT100 | UK FTSE 100 | 3.4% | 6.6% | 6.6% | 18.3% | 15.9% | 11.0% | 10.6% | 9.2% |
| DJSX50 | Euro STOXX 50 | 2.8% | 14.1% | 14.1% | 28.1% | 17.9% | 16.6% | 13.6% | 11.3% |
| FJNK | Japan Nikkei 225 | 1.1% | 17.0% | 17.0% | 37.0% | 11.2% | 15.0% | 14.3% | 15.0% |
| | **Currency Movement** | | | | | | | | |
| USDZAR | Rand/Dollar (R18.88= 1 Dollar) | -1.7% | 2.8% | 2.8% | 6.1% | 8.5% | 5.4% | 5.0% | 6.0% |
| EURZAR | Rand/Euro (R20.37= 1 Euro) | -1.8% | 0.9% | 0.9% | 5.6% | 5.5% | 4.6% | 5.2% | 3.5% |
| ZARJPY | JPY/Rand (8.02 Japanese Yen= 1 SA Rand) | 2.6% | 4.0% | 4.0% | 7.4% | 2.3% | 1.0% | -0.5% | -2.0% |
| GBPZAR | Rand/Pound (R23.83= 1 Pound) | -1.6% | 2.3% | 2.3% | 8.6% | 5.4% | 4.8% | 5.1% | 3.1% |

MENTENOVA

# CONTACT

**Contributors: Kwasi Acheampong, Erik Labuschange Bonnita Modukanele, Seala Molefe, Neo Sithole, and Yanni Yang**

**T** +27 11 447 7716
**F** 086 272 1177 **E** info@mentenova.co.za

3rd Floor, Oxford & Glenhove Building 2,
114 Oxford Road, Rosebank, Johannesburg
www.Mentenova.co.za