MENTENOVA

ECONOMIC OVERVIEW

QUARTER 3, 2023

Synopsis

- In the face of a sharp global slowdown, the US continued to show economic resilience over the quarter.
- The US paints an optimistic picture of a perfect soft landing. However, some downside risk has built up in the face of certain fiscal support programmes falling away and a cooling labour market, set against a backdrop of weak growth in the Eurozone and China and a global trade recession.
- China's recovery is losing momentum as Asia's largest economy grapples with a growing property crisis that threatens the country's economic prospects.
- Easing-of-inflation cycles have commenced in numerous economies, albeit at different paces.
- There has been a major sell-off in the bond markets following the readjustment of the fiscal deficit target and the growth forecast for the next 12 months. Bond yields hit a record high in the UK and Eurozone area.
- The South African Reserve Bank (SARB) has revised its 2023 growth estimate from 0.4% to 0.7%, as power and logistical constraints continue to hamper economic activities.
- There has been an improvement in South Africa's business and consumer confidence, aided by a short-term recovery of the Rand.

Economic and Market Overview

<table>
<tr>
<td>United States</td>
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There has been a slight easing in the US labour markets since August 2023, with the unemployment rate ticking up to 3.8% and the quit rate showing a decline.
There has been a surge in bond yields resulting from a combination of consumer resilience, increasing treasury issuance to fund fiscal spending and the prospect of a soft landing.
The US economy has been one of the best performers due to its expansionary fiscal policy.
The Fed is expecting higher rates for longer.

US consumers have remained very resilient post-Covid, especially with excess savings accumulating during the pandemic, fiscal support programmes, fixed-rate 30-year mortgages and a very tight labour market. Such resilience only started to show signs of waning in the second half of Q3 2023. This was evident in the consumer confidence indices and weaker new home sales in August and September.
The US labour market has also begun to show signs of easing since August, with the unemployment rate ticking up to 3.8% in August after hovering around 3.5% and 3.7% for most of 2022 and into 2023. The quit rate, which indicates the ease of finding a replacement job, has also declined steadily, from a peak of 3.0% to 2.3%. However, the overall labour market remains tight, with excess demand for labour at an elevated level, as shown in Figure 1. Wage growth has declined from a peak of 5.9% in March 2022 to 4.3% in August 2023, as shown in Figure 2. However, for services inflation to cool sustainably to reach the Fed's inflation target of 2.0%, wage growth in the US still has some way to fall.
The Fed revised both its economic growth and inflation forecasts upwards during its September meeting. While traditional measures of recession are indicating a significant slowdown within the next 12 months, the market has been pricing in a scenario of a perfect soft landing. Consumer resilience, together with productivity-led economic growth and a manufacturing investment boom, have boosted US corporate earnings, resulting in another strong quarter in Q2. The US also saw a GDP QoQ annualised growth rate of 2.1% in the second quarter.
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The S&P 500 Total Return Index returned 1.6% in dollar terms for the first two months of the quarter before ending with -3.3% for Q3 as softer data began coming through. The combination of consumer resilience, increasing treasury issuance to fund fiscal spending and the prospect of a soft landing have resulted in surging bond yields. The WGBI returned -4.3% for the quarter and -2.7% for the year to date as of 30 September 2023.

Figure 1: US labour excess demand

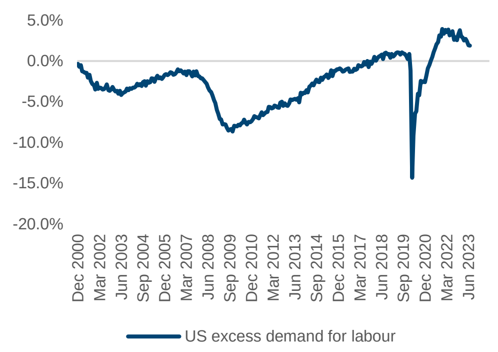
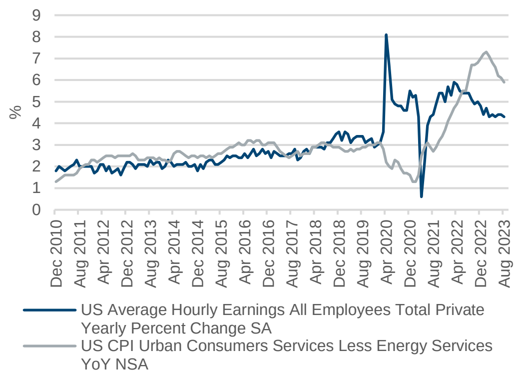


Figure 2: US wage growth and core services inflation



Source: Bloomberg

The US economy has been one of the best performers due to its pro-cyclical fiscal policy, as shown in Figure 3. However, some downside risk has been building up in the wake of certain fiscal support programmes falling away and the labour market cooling, set against the backdrop of weak economic growth in the Eurozone and China and a global trade recession (which often coincides with a US recession). Small and medium-sized businesses are most vulnerable in this higher-rates-for-longer scenario. The number of bankruptcies in the US has already picked up, as shown in Figure 4. Small and regional banks are also more exposed to negative net income growth, where funding costs have increased significantly because of competition (for deposits) with money market funds.

Figure 3: Economic surprises indices

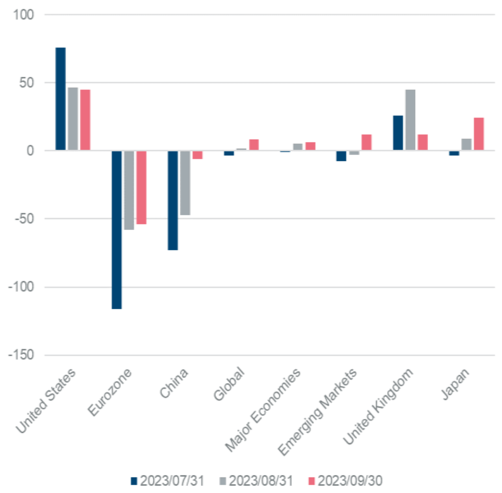
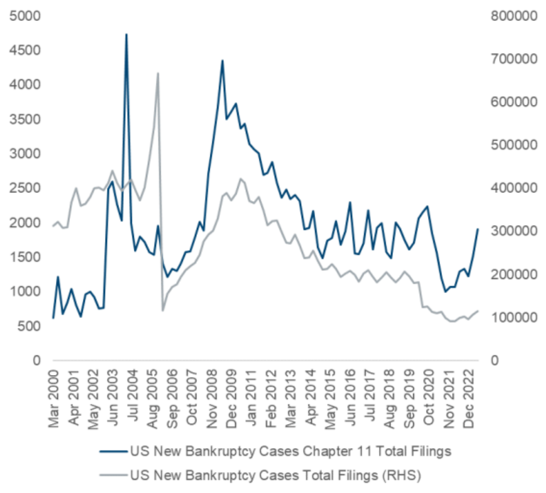


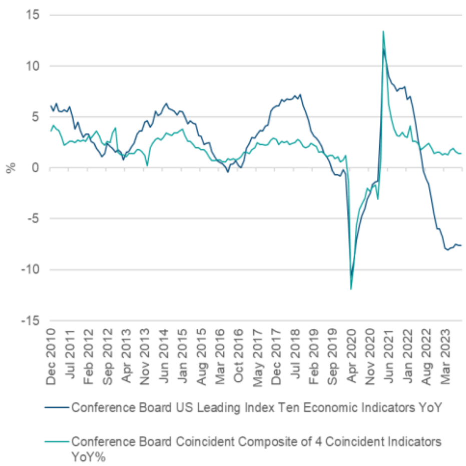
Figure 4: Number of bankruptcies



Source: Bloomberg

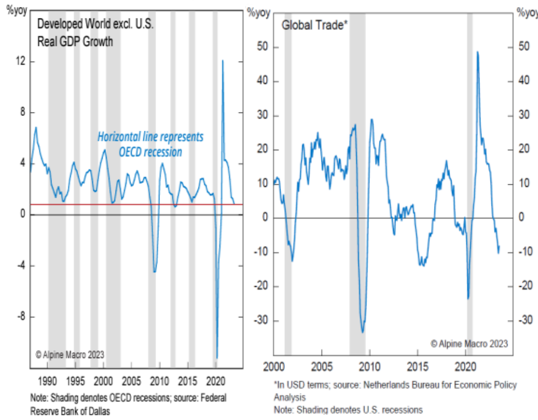
There is not much room for error as valuations have priced in a Goldilocks scenario of falling inflation without too much economic pain. A slowdown creates the worst environment for risk assets, but the Fed can act quickly this time to cut rates as we are entering this period of slowdown with inflation already falling. It remains to be seen how the gap between the leading and coincidental economic indicators, as shown in Figure 5, will be narrowed over the coming quarters. However, given the Fed's hawkish stance, the withdrawal of fiscal support and growth in the rest of the world treading water, there is an increasing probability that the US will become economically weaker in the months to come.

Figure 5: Coincidental vs leading indicator



Source:Bloomberg, AlpineMacro

Figure 6: World GDP growth and global trade recession



UK and Eurozone

- **The ECB's deposit facility rate is currently at a record high of 4.00%.**
- **Equities (STOXX 600) declined by a significant 5.11% over the quarter.**
- **There was a major sell-off in the bond market as a result of readjustments to the fiscal deficit target and growth forecast for the next 12 months. Bond yields hit a record high.**
- **Inflation remains sticky in the region, due to a tight labour market and resilient consumption levels.**

The European Central Bank (ECB) hiked rates by 25 bps in September, with the deposit facility rate currently standing at 4.00% – its highest level in more than two decades. Interest rates are much higher in the UK at 5.25%, coinciding with its high inflation rate of 6.80%. These elevated inflation rates are putting noticeable pressure on the equity market, evidenced by the STOXX 600 experiencing a significant 5.11% contraction in Q3. However, it is worth noting that the index remains positive for the year to date, with performance at 15.87% – largely attributable to robust gains both in Q1 and Q2.

There was a pronounced bond market sell-off over the recent quarter. This is primarily attributable to significant fiscal policy adjustments by various governments, notably Italy, which readjusted its fiscal deficit targets and growth projections for the next 12 months. This means that governments will need to accrue more debt to supplement their deficits. Consequently, bond yields have surged to historic levels, both in the UK and the Eurozone, to compensate investors for the additional risk embedded in government bonds, as prices continue to fall.

The sell-off was also prompted by concerns that the Fed may keep interest rates higher for longer, which suggests that the Bank of England (BOE) and the ECB would need to follow suit. This would put additional pressure on already constrained economies.

Figure 7: Interest rate hikes relative to inflation

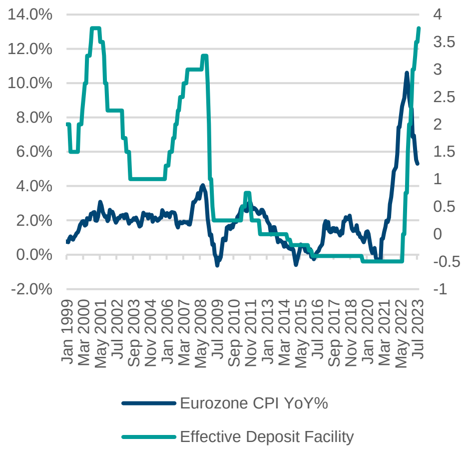
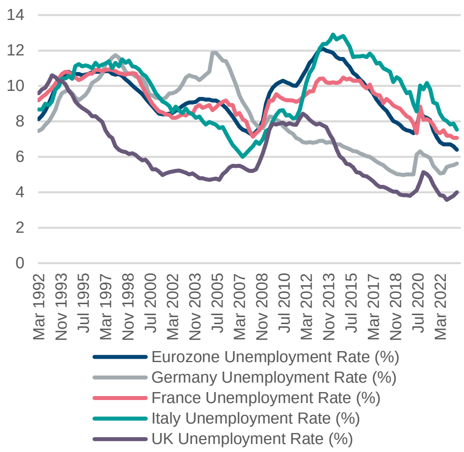


Figure 8: Unemployment rates

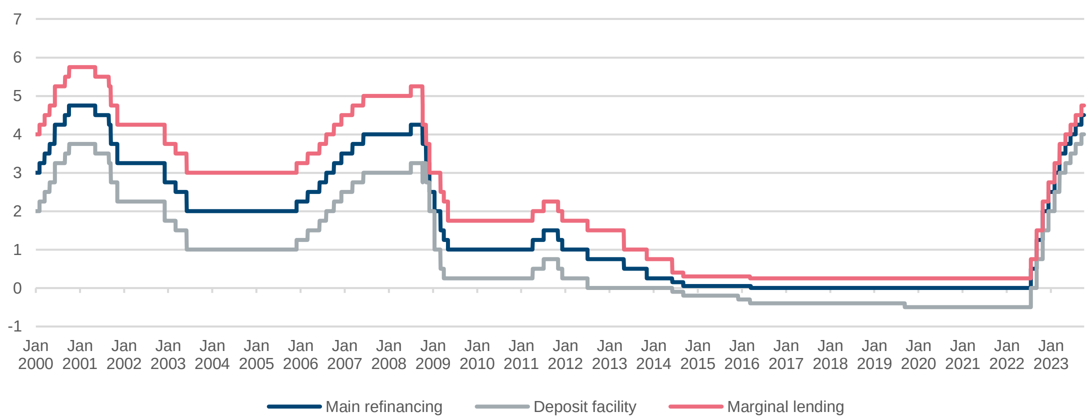


Source: Bloomberg

Inflation remains sticky in the Eurozone due to a declining unemployment rate. Although inflation is falling, it is still outside the ECB's target range of 2.00%. The ECB is expecting to achieve an inflation rate of 2.20% by 2025. This is going to prove to be quite difficult if the labour market continues to strengthen, and so the ECB has not ruled out the possibility of further rate hikes, despite the Eurozone approaching a recession.

Despite strong labour markets, productivity rates are declining in most countries YoY. In the UK, there has been a notable increase in wage growth within the public sector, but this trend has likely reached its peak. Conversely, there has been a decline in wage growth in manufacturing, services and private sector. This downward shift is deemed necessary to curb inflation through further reducing consumption in the UK and Eurozone. A weak growth outlook is anticipated, given the high cost of living and oil prices as well as slowing global trade, with the likes of China having low growth expectations, which will spill over into the demand for foreign goods.

Figure 9: European Central Bank rate as of 20 September 2023



Source: Bloomberg

Japan

- **There was a decline in the GDP growth rate over the quarter, dropping from 1.5% to 1.2%.**
- **Equity markets fell by 4.0% during Q3 2023.**
- **The Yen continued to weaken against the USD, falling to an 11-month low.**

The Japanese economy experienced headwinds in Q3, with a decline in manufacturing output in August and September, and lower consumer spending and tourism numbers due to tensions with China. This offset the benefits accruing to Japan's exports from a weakened Yen. The more constrained economic growth was evident in the Q2 GDP dropping from 1.5% to 1.2%.

Equities fell by 7.3% in USD term (-4.0% in JPY) during Q3, underperforming against the MSCI World Developed Market Index (excl. Japan) by 5.2%, as shown in Figure 10. The quarter was a difficult one for Japanese manufacturers, as shown in the Bank of Japan's (BOJ) Manufacturing PMI. The PMI showed a continued downward trend, which started at the tail–end of the previous quarter, from 49.8 to 48.5 at the end of Q3. This was due to a significant drop in new orders and continued weakness in export performance, particularly to the Chinese market amidst rising tensions over the Fukishima wastewater release.

The Japanese Business Confidence number measured by the Japan Tankan Large Manufacturing Index jumped to 9 in Q3 from 5 in Q2. The Japan Tankan Large Non-Manufacturing Index also increased significantly from the previous quarter to 23, a number not seen since 1991 when Japan experienced an asset–inflation bubble. This shows that Japanese business expects a durable economic recovery, even as economies slow down around the world.

Figure 10: Nikkei 225 vs. peers

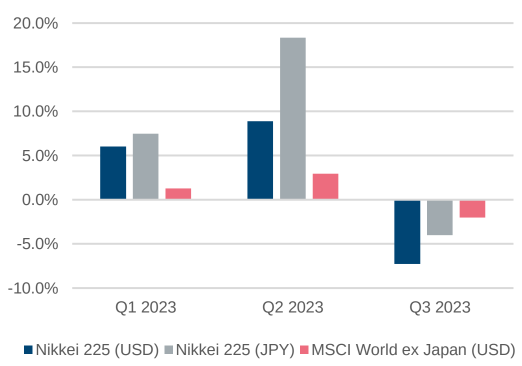


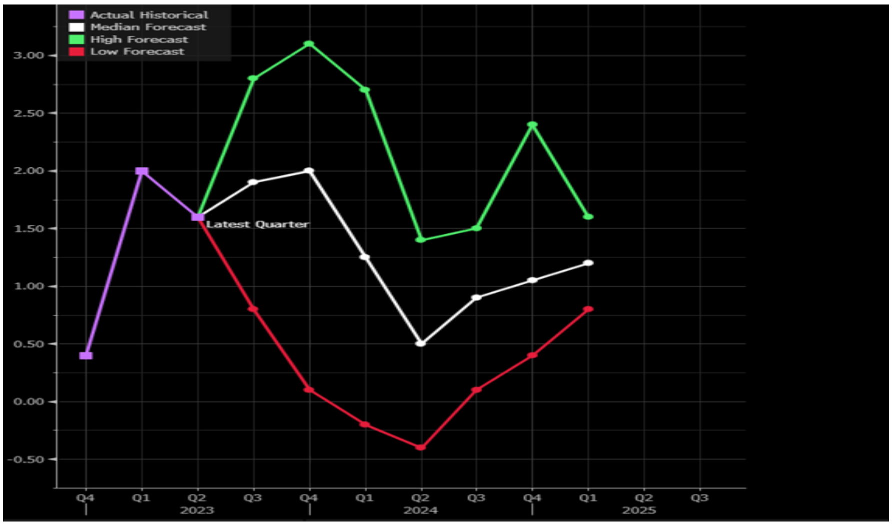
Figure 11: Japan manufacturing PMI

Source: Bloomberg

The Yen continued to show general weakness against the USD, falling to an 11-month low. This was due to the growing interest rate differential between the dollar (at a target range of 5.25% to 5.5%) and the Yen (-0.1%). The Yen fell to the 150 mark, which was the level at which the BOJ had previously (last year) intervened to prop up the falling currency. This time around, the level of the currency has not prompted any action from the BOJ this time around.

Even though Japan experienced headwinds in Q3, Japanese businesses are optimistic about Q4 and believe that final economic numbers for Q3 will paint a picture that is rosier than that painted by the current interim numbers. This is reflected in the Bloomberg Economic Analysts Forecasts, with the more recent updates pointing to a higher expected real GDP growth rate for Q3 than the 1.9% in Q2, against the previous 1.6%. The easing of control on the yield curve will also allow the Yen to appreciate, which should in turn ease the pressure on Japanese consumers.

Figure 12: Economic forecast



Source: Bloomberg

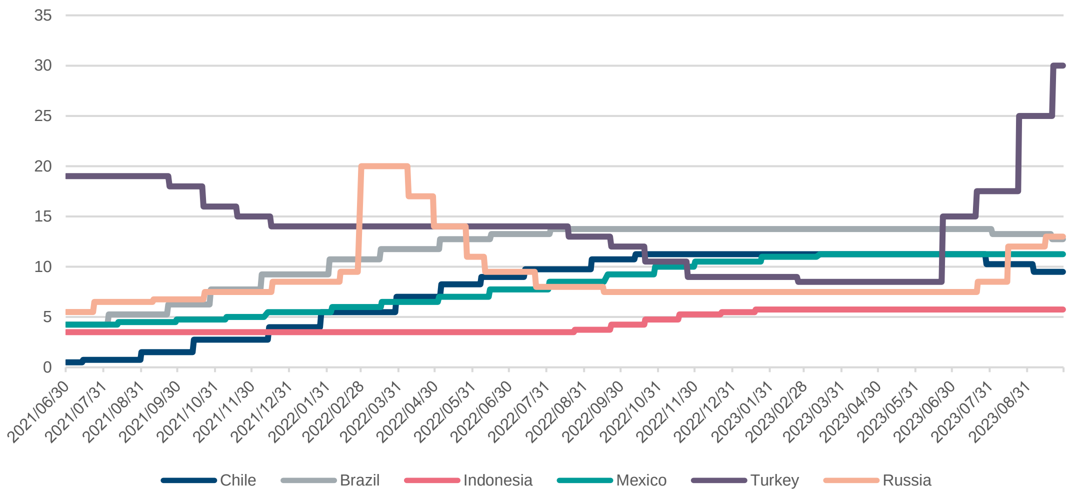
Emerging markets

- **The outperformance of EM equities compared to the developed markets was short-lived as EM equities fell sharply in August 2023 in the face of deteriorating risk sentiment.**
- **LATAM central banks have begun an easing cycle in response to global inflation surges in 2021–2022.**
- **The rate hike in Thailand came as a surprise in view of the uncertain economic outlook and market expectations of a rates hike pause.**
- **The World Bank has forecast lower growth in China over the next 12 months as Asia's largest economy grapples with an escalating property crisis that threatens the country's economic prospects.**

As the Chinese government signalled it would provide economic assistance in the face of declining real estate sales and consumption at the start of Q3, emerging-market (EM) equities rallied and outperformed developed-market equities. However, this was short-lived, as EM equities fell sharply in August in the face of deteriorating risk sentiment induced, for example, by the Chinese economy's persistent downturn and property crisis.

EM central banks have commenced their easing cycles after their quick response to the global inflation surge of 2021–2022. This inflationary shock prompted EM central banks to raise interest rates in the first quarter of 2021 which, by the third quarter of 2023, had brought inflation under control and triggered an economic rebound. Chile and Brazil, in particular, were at the forefront of the hikes and have recently begun to reduce their rates. South Korea, Indonesia, Mexico, India and Poland are among the EMs whose central banks have kept interest rates the same. In contrast, Turkey, Russia and Thailand have hiked their rates. The surprise move by Thailand has cast uncertainty over the nation's economic outlook as it was expected to keep rates on hold.

Figure 13: Historical interest rates in Chile, Brazil, Indonesia, Mexico, Turkey and Russia



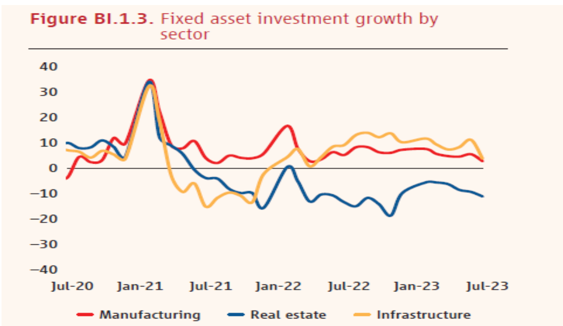
Source: Bloomberg

The World Bank has lowered its growth forecast for China for the next 12 months, as Asia's largest economy grapples with an escalating property crisis that is threatening to undermine the country's economic prospects. There were some developments in this quarter in terms of the real estate crisis. Evergrande's founder and chairman, Xu Jiayin, and numerous staff members were arrested. After the Chinese government implemented the “three red lines” policy in August 2020, the company subsequently defaulted on its debt two years ago. The purpose of the policy, which was implemented to limit real estate developers' gearing ratios, was to govern the amount of leverage that property developers could have. Country Garden, China's largest property developer, felt the impact of the policy and warned of impending loan defaults after reporting a 48.9-billion-yuan (R130 billion) loss in the first half of the year.

Country Garden missed its bond repayment due in August and requested a 40-day grace period for a bond worth 3.9 billion yuan (R10.5 billion). The Chinese property developer was able to reach an agreement with its creditors and settled the late bond repayment in early September. The real estate sector accounts for over 30% of China's GDP, and a crash in the industry may severely damage the financial system and the Chinese economy, with ripple effects in neighbouring regions.

Figure 14: Hang Seng Mainland Property Index

Figure 15: Poor performance in default-ridden sector amidst payment pressures



Source: Financial Times, World Bank

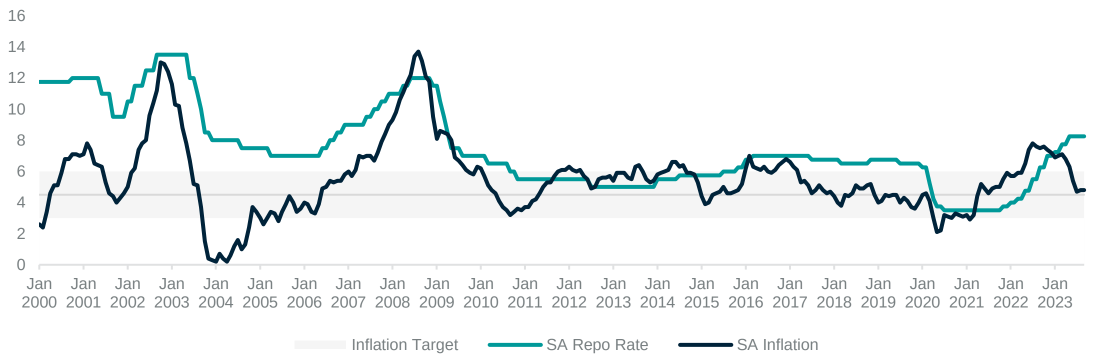
South Africa

- **Improvements in business and consumer confidence were aided by a short-term recovery of the Rand.**
- **The manufacturing sectors faced challenges over the quarter, with the PMI number declining from 49.8 in August to 45.4 in September.**
- **The ongoing energy crisis over the quarter spilled over into the economic growth forecast revision.**
- **Investment opportunities rose as the monetary policy pivot nears.**
- **With the major sell-off of global bonds, lower bond prices and higher yields were seen in South Africa. Long-dated domestic bonds are currently trading at a yield to maturity of 12%, with the potential to reach 15%.**

Business and consumer confidence in South Africa saw a notable improvement during the third quarter of the year. This positive shift can be attributed to several factors, including a more favourable growth outlook, lower inflation and reduced geopolitical tensions. Key contributors to this revival include a proactive monetary policy, enhanced cooperation between business and government in energy and logistics, and South Africa’s successful hosting of the annual BRICS summit.

Policy uncertainty in South Africa declined from its earlier high, reaching 71.8, following a better-than-expected 0.6% growth rate in the second quarter. The improvements in business and consumer confidence were aided by the short-term recovery of the Rand, which rebounded from its previous high in the second quarter to its closing value of R18.92/$ in the third quarter. Concurrently, inflation dropped to a 2-year low of 4.7% in July 2023, returning to the mid-range of the SARB's inflation target.

Figure 16: SA inflation and repo rates

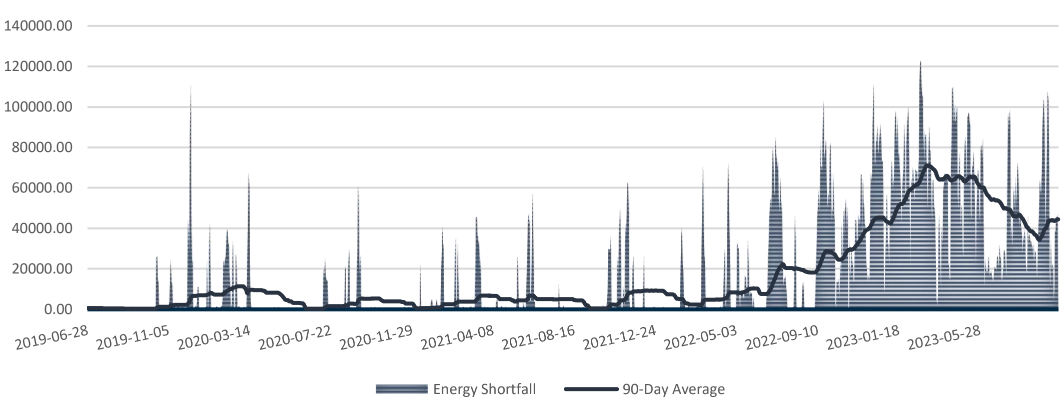


Source: Bloomberg

The manufacturing sector faced challenges in Q3, with the Absa Purchasing Managers' Index (PMI) dropping from 49.8 in August to 45.4 in September. Factors such as higher fuel prices, elevated borrowing costs and weak growth led to suppressed local and global demand and were reflected in falling export and new sales indices. These adverse conditions prompted a decline in average business activity over the quarter to 6.8, negatively impacting manufacturing output and employment. This dims the outlook for GDP in Q3.

The SARB has revised South Africa's economic growth forecast upwards for this year, from 0.4% to 0.7%. Owing to the prolonged energy crisis and the additional financial burden created by the R254 billion extended to Eskom to support its debt obligations, the debt-to-GDP ratio deteriorated to 73.6%, with the August budget balance showing a record deficit of R143 billion. These fiscal challenges have significant implications for the Rand, inflation and long bond prices.

Figure 17: SA energy shortfall



Source: Bloomberg

South Africa's financial challenges have been exacerbated by a global sell-off of government bonds, resulting in lower bond prices and higher yields. Long-dated domestic bonds, currently trading at around 12%, may potentially reach 15%, thus leading to further ballooning of government debt and increased borrowing costs. This oversold domestic bond market has implications for mortgage rates and lending rates.

As the monetary policy reaches peak tightness, there are investment opportunities in SA-listed property. While short-term domestic property performance has been subdued as the rate hiking cycle approaches its peak, potential tailwinds may be expected. Similarly, gold is becoming more attractive as the interest rate hiking cycle nears its peak. Investors may shift from bonds to gold, given the inverse relationship between precious metal prices and interest rates.

The Rand is undervalued, yet the inherent risks associated with South Africa continue to demand a premium, keeping the currency aloft. The Rand has depreciated 13.5% against the dollar, with only the Turkish lira, Argentine peso and Russian ruble performing worse in the year to date. Economic growth constraints and the higher-rates-for-longer narrative are driving concerns about an economic recession. Although headline inflation is moderating, persistently high food prices and tightening oil markets, along with supply shortfalls, are contributing to elevated core inflation.

The November AGOA summit is expected to strengthen trade relations between South Africa and the US, fostering more resilient, sustainable and inclusive economic growth. Recent developments, including a favourable outcome from the Lady R inquiry and the upcoming EU–SA Summit, have also reduced some foreign policy risks.

APPENDIX

Financial market performance as at 30 September 2023 (in 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)	-2.5%	-3.5%	2.2%	17.7%	14.5%	9.3%	8.6%	8.6%
FTSE/JSE Resources 20 Index	1.0%	-5.4%	-15.3%	-0.5%	8.7%	11.4%	13.7%	5.9%
FTSE/JSE Industrials Index	-4.1%	-6.2%	10.1%	27.4%	12.9%	8.9%	6.7%	8.3%
FTSE/JSE Financials Index	-3.8%	1.7%	6.8%	20.6%	21.0%	3.3%	4.5%	7.0%
FTSE/JSE Shareholder Weighted Index (SWIX)	-3.1%	-4.0%	-0.2%	12.2%	11.2%	6.2%	5.5%	7.1%
FTSE/JSE Capped Swix Index (Capped SWIX)	-3.0%	-3.8%	-0.3%	11.9%	13.8%	6.4%	5.4%	6.9%
FTSE/JSE All-Share Top 40 Index	-3.1%	-4.6%	2.3%	19.8%	14.2%	9.9%	9.2%	8.8%
FTSE/JSE SWIX Top 40 Index	-3.7%	-5.3%	-0.5%	13.4%	9.9%	6.0%	5.5%	7.0%
FTSE/JSE Mid Cap Index	-1.1%	0.9%	-0.3%	7.7%	14.1%	5.8%	3.4%	6.4%
FTSE/JSE Small Cap Index	-2.0%	1.1%	2.4%	7.0%	28.8%	9.2%	5.8%	7.9%
FTSE/JSE Listed Property Index (SAPY)	-4.1%	-1.0%	-5.4%	12.9%	16.8%	-3.5%	-3.6%	1.5%
FTSE/JSE Capped Listed Property Index	-3.8%	-0.6%	-4.4%	13.1%	16.5%	-6.1%	-6.0%	-0.5%
Local Interest-Bearing Indices								
FTSE/JSE All-Bond Index (ALBI)	-2.3%	-0.3%	1.5%	7.2%	7.0%	7.2%	7.3%	7.2%
FTSE/JSE All-Bond Index 1 - 3 years	-0.4%	2.0%	4.9%	8.8%	5.4%	7.6%	7.7%	7.4%
FTSE/JSE All-Bond Index 3 - 7 years	-1.2%	1.4%	4.4%	9.2%	5.5%	8.6%	8.4%	8.1%
FTSE/JSE All-Bond Index 7 - 12 years	-2.8%	-0.6%	2.3%	8.7%	7.1%	7.8%	7.9%	7.4%
FTSE/JSE All-Bond Index +12 years	-3.0%	-1.6%	-1.6%	4.1%	7.7%	6.1%	6.5%	6.6%
Inflation Linked Government Bonds (IGOV)	-1.1%	0.7%	0.8%	3.0%	8.6%	5.3%	4.0%	5.2%
Short-Term Fixed Interest Composite Index (SteFi)	0.7%	2.0%	5.8%	7.5%	5.3%	5.9%	6.3%	6.3%
Inflation Index								
Consumer Price Index (1 month lagged)	0.3%	1.4%	3.6%	4.8%	5.8%	4.9%	4.9%	5.1%
International Indices								
MSCI World Index	-4.3%	-2.9%	23.7%	28.1%	13.2%	14.2%	15.0%	15.9%
MSCI Emerging Market Index	-2.6%	-2.3%	13.3%	17.3%	2.8%	6.9%	8.4%	9.1%
FTSE World Government Bond Index (WGBI)	-3.2%	-3.8%	7.9%	5.6%	-4.9%	3.2%	2.1%	5.3%
S&P Global Property	-5.4%	-4.2%	6.9%	8.3%	4.9%	5.5%	5.5%	9.5%
USA S&P 500	-4.8%	-2.8%	25.4%	27.1%	14.8%	16.4%	17.5%	19.2%
UK FTSE 100	-1.3%	-1.4%	18.0%	31.5%	15.8%	8.9%	9.4%	9.4%
Euro STOXX 50	-5.1%	-7.4%	23.3%	45.7%	12.7%	10.9%	11.4%	10.5%
Japan Nikkei 225	-4.2%	-6.1%	21.0%	27.0%	5.3%	8.2%	11.0%	12.7%
Currency Movement								
Rand/Dollar (R18.92= 1 Dollar)	0.2%	0.4%	11.1%	4.6%	4.2%	6.0%	4.7%	6.6%
Rand/Euro (R20= 1 Euro)	-2.3%	-2.9%	9.6%	12.8%	0.6%	4.0%	3.8%	4.0%
JPY/Rand (7.89 Japanese Yen= 1 SA Rand)	2.4%	3.1%	2.5%	-1.3%	7.8%	-0.4%	1.0%	-2.1%
Rand/Pound (R23.08= 1 Pound)	-3.5%	-3.6%	12.1%	14.2%	2.2%	4.6%	3.8%	3.6%

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