MENTENOVA

ECONOMIC OVERVIEW

QUARTER 2, 2023

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EXECUTIVE SUMMARY

Financial markets were broadly positive in the first half of 2023 – providing welcome relief to investors after the losses seen in 2022. However, the first half of the year was not all smooth sailing. From rising interest rates to bank failures and political uncertainty, the environment was challenging to navigate.

Notwithstanding these challenges, global equities recorded solid gains for the first six months of the year after developed market economies proved more resilient than expected. The S&P 500, for instance, returned almost 30% in ZAR terms in H1 2023, largely driven by the big tech companies amid promising growth prospects surrounding artificial intelligence (AI). As it is adapted, this revolutionary technology is expected to drive enormous productivity gains and to augment economic growth, supporting companies that facilitate its infrastructure, such as cloud computing vendors and hardware manufacturers.

Rand weakness had a big part to play in the Rand-denominated returns for local investors after the currency weakened by more than 10% in the first six months amid persistent loadshedding and concerns surrounding the outlook for the domestic economy. Currency volatility was particularly pronounced during the second quarter after SA's relations with China came under the spotlight, weighing on sentiment. The South African Reserve Bank (SARB) responded to these developments and sticky inflation by hiking rates by an additional 50bps in May.

With domestic growth expected to be practically flat this year, SA Inc stocks have struggled to keep up with the momentum displayed by global peers. The Capped SWIX has been primarily supported by the performance of the industrials sector and Rand hedge counters, which has offset the weakness in the resources sector amid weaker precious metals and miners. The listed property market has meanwhile struggled to gain any traction and ended the second quarter practically flat after a difficult Q1.

Global central banks delivered additional interest rate hikes during the quarter in the face of strong labour market dynamics in major developed economies and still-elevated core inflation. Further rate hikes have narrowed the gap between dividend yields and bond yields, attracting investors back into the global bond market and supporting returns from global bonds.

Looking ahead, investors continue to face uncertainty. Traditional indicators are still pointing to a high probability of a US recession in the coming quarters, while stubborn inflation and strong labour markets are keeping the pressure on central banks to tighten policy. These dynamics suggest that there are still downside risks to corporate earnings in the current environment, with tighter liquidity and credit conditions expected to restrain economic activity. Meanwhile, domestic headwinds and uncertainty surrounding SA's foreign policy, set against a backdrop of global recession worries and global geopolitical tensions, make SA assets increasingly vulnerable to changes in the global risk appetite and liquidity conditions.

While market conditions remain challenging to navigate, opportunities are plentiful for investors with long-term investment horizons, and a disciplined approach to investing remains the best way to achieve long-term goals.

ECONOMIC AND MARKET OVERVIEW

TECH STOCKS DRIVE GLOBAL EQUITY MARKETS IN H12023

Equity markets across the globe were broadly higher for the first half of the year, helping investors recover from double-digit declines recorded in 2022. Developed market equities outperformed emerging market equities on aggregate as developed market economies proved resilient despite a continuation of interest rate hikes to fight inflation.

The S&P 500 gained close to 16% in USD terms in the first half. However, these gains were not evenly spread across sectors as a handful of stocks, known as the Big 7 (i.e., Apple, Microsoft, Amazon, Nvidia, Meta, Alphabet and Tesla), drove a large proportion of these returns amid promising growth prospects surrounding generative AI. As it is adapted, this revolutionary technology is expected to drive enormous productivity gains and augment economic growth. In the face of a resilient US economy and optimism surrounding this new technology, information technology and communication services have gone from the worst-performing sectors in 2022 to the best-performing sectors in 2023.

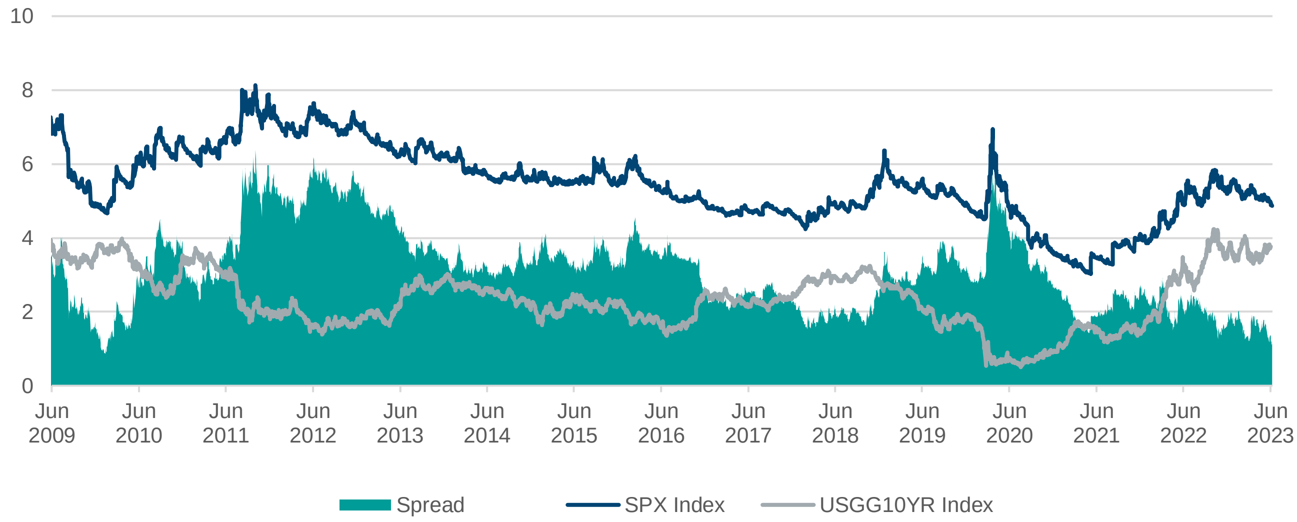
Chart 1: S&P 500 sector annual performance ranking (as at end May 2023)

2017	2018	2019	2020	2021	2022	2023 so far	+/- YTD perf
Information Technology 37 %	Health Care 4.7 %	Information Technology 48 %	Information Technology 42 %	Energy 48 %	Energy 59 %	Information Technology 30 %	↑
Materials 21 %	Utilities 0.46 %	Comm. Services 31 %	Consumer Discretionary 32 %	Real Estate 42 %	Utilities -1.4 %	Comm. Services 30 %	↑
Consumer Discretionary 21 %	Consumer Discretionary -0.49 %	Financials 29 %	Comm. Services 22 %	Information Technology 33 %	Consumer Staples -3.2 %	Consumer Discretionary 16 %	↑
Financials 20 %	Information Technology -1.6 %	Industrials 27 %	Materials 18 %	Financials 33 %	Health Care -3.6 %	Industrials -0.89 %	↓
Health Care 20 %	Real Estate -5.6 %	Consumer Discretionary 26 %	Health Care 11 %	Materials 25 %	Industrials -7.1 %	Consumer Staples -2.2 %	↓
Industrials 19 %	Consumer Staples -11 %	Real Estate 25 %	Industrials 9 %	Health Care 24 %	Financials -12 %	Materials -2.5 %	↓
Consumer Staples 10 %	Financials -15 %	Consumer Staples 24 %	Consumer Staples 7.6 %	Consumer Discretionary 24 %	Materials -14 %	Real Estate -4.9 %	↓
Utilities 8.3 %	Industrials -15 %	Utilities 22 %	Utilities -2.8 %	Comm. Services 21 %	Real Estate -28 %	Health Care -6.3 %	↓
Real Estate 7.2 %	Comm. Services -16 %	Materials 22 %	Financials -4.1 %	Industrials 19 %	Information Technology -29 %	Financials -7.2 %	↓
Energy -3.8 %	Materials -16 %	Health Care 19 %	Real Estate -5.2 %	Consumer Staples 16 %	Consumer Discretionary -38 %	Utilities -8.9 %	↓
Comm. Services -6 %	Energy -20 %	Energy 7.6 %	Energy -37 %	Utilities 14 %	Comm. Services -40 %	Energy -10 %	↓

Source: Macrobond

Bond markets worldwide also produced gains in the first half, albeit modest, as higher interest rates across the globe narrowed the gap between the dividend yields and bond yields, attracting investors back into the global bond market. This is illustrated by the declining spread between the S&P 500 dividend yield and the yield on 10-year US government bonds (green shaded area in Chart 2), which is now at its lowest level since 2009.

Chart 2: S&P 500 dividend yield vs 10-year US treasury yield

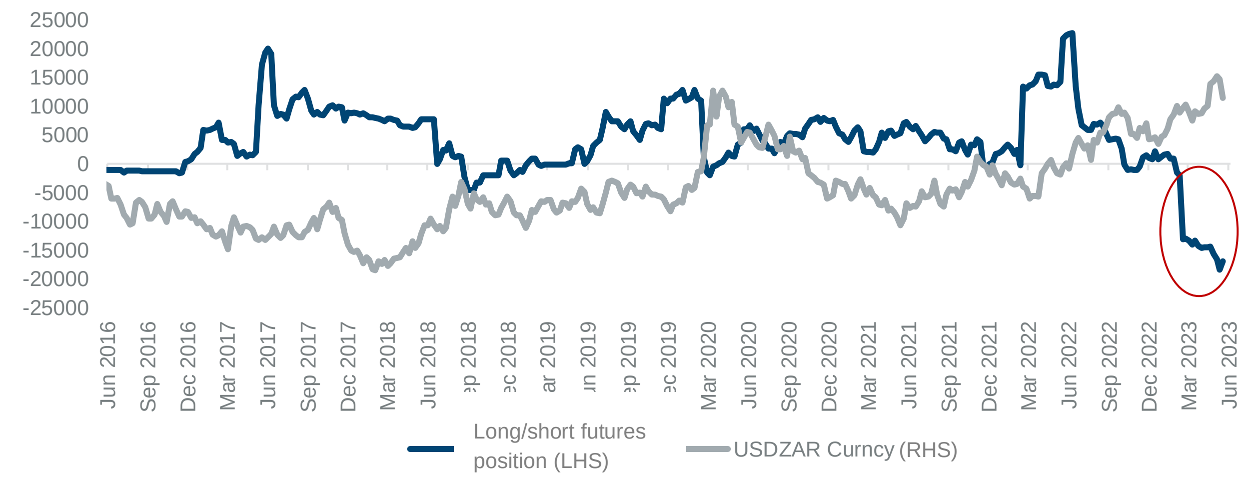


Source: Bloomberg

SA ASSETS STRUGGLE TO KEEP UP AS LOCAL RISKS MOUNT

The Rand was the third worst-performing emerging market currency against the USD in the first six months as mounting domestic risks weighed on appetite for SA assets and the Rand – especially in the wake of South Africa being accused of providing weapons and ammunition to Russia, prompting fears of possible sanctions if found to be valid. The bearish sentiment surrounding the Rand was evident in the futures market as speculators took unprecedented short positions in the USD/ZAR towards the end of Q2.

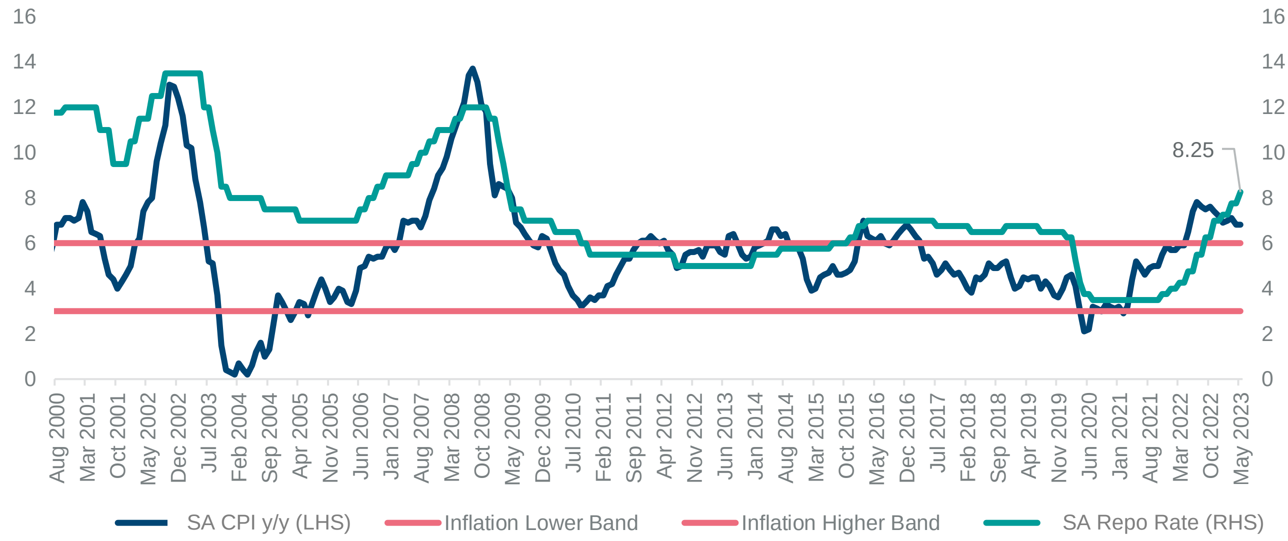
Chart 3: CFTC CME South African Rand non-comm net contracts/futures position and the USD/ZAR exchange rate



Source: Bloomberg

This kept the pressure on the South African Reserve Bank (SARB) to continue raising interest rates to protect the value of the currency and bring down inflation. Specifically, the SARB increased rates by an additional 50bps in May, taking the repo rate up to 8.25%, which, according to the central bank, now places rates in restrictive territory.

Chart 4: SA consumer price inflation year-on-year vs SA repo rate since 2000

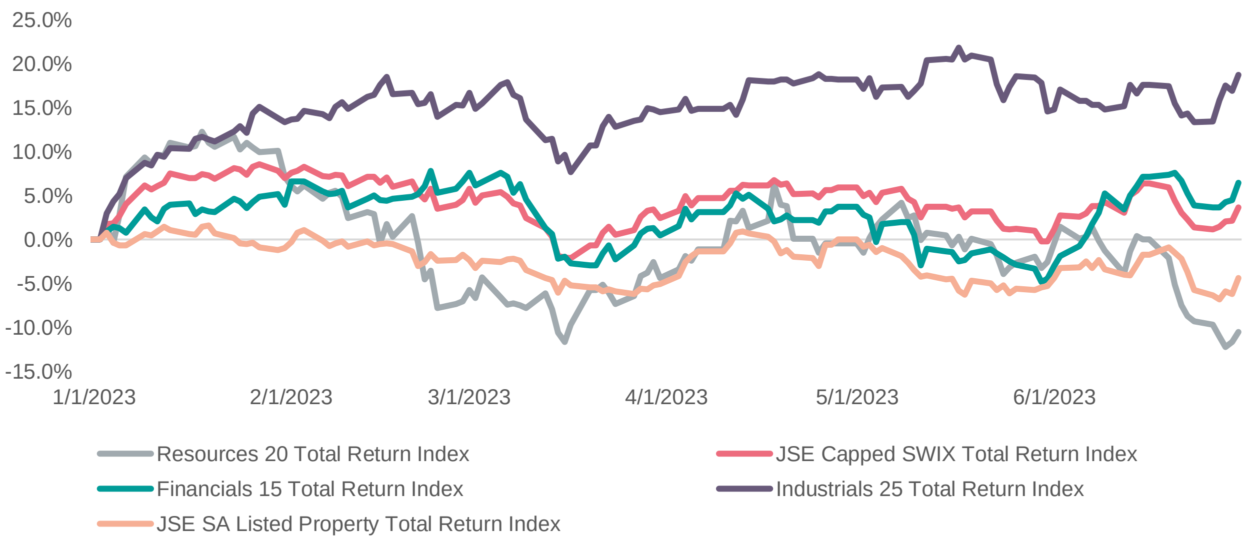


Source: Bloomberg

It is against this backdrop that local bond markets came under some pressure in the second quarter, with the All Bond Index down 1.5% for the quarter. Moreover, the yield on South Africa's 10-year bond increased to a high of 12.4% towards the end of May, reflecting the sharp rise in the risk premium charged on Rand-denominated borrowing as domestic structural challenges continue to mount.

SA equities also underperformed against most global peers as SA consumers remained under pressure and the outlook for growth remained bleak. With domestic growth expected to be practically flat this year, SA Inc has struggled to keep up with the momentum displayed by global peers. The Capped SWIX has been primarily supported by the performance of the industrials sector and Rand hedge counters, which has offset the weakness in the resources sector amid weaker precious metals and miners. The listed property market has meanwhile struggled to gain any traction, ending the second quarter practically flat after a difficult Q1.

Chart 5: SA Index performance to 30 June 2023 (% return for H1 2023)

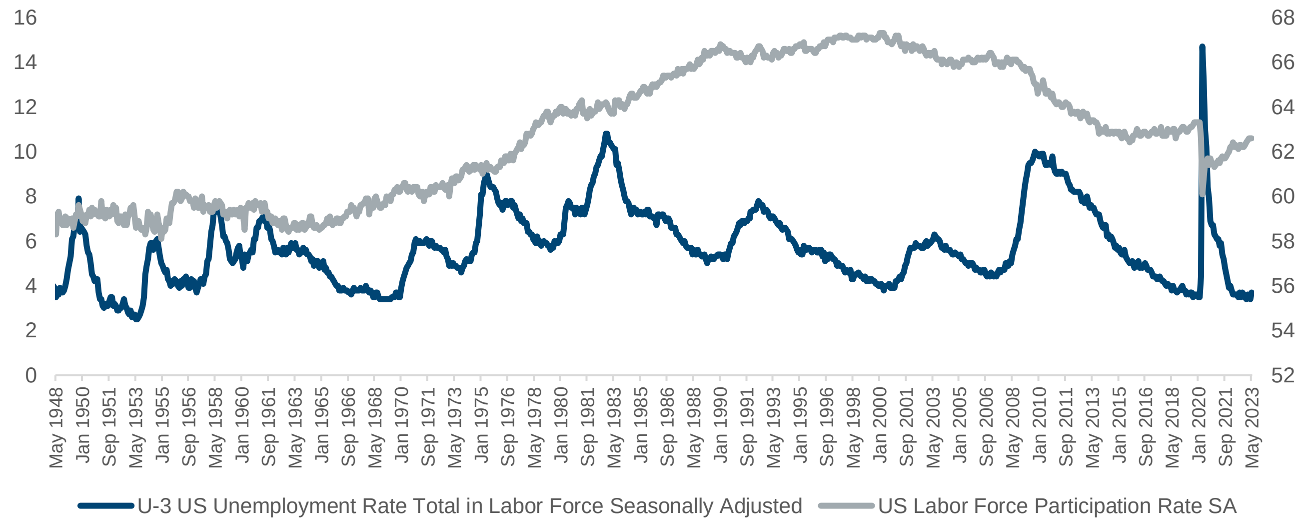


Source: Bloomberg

TIGHT LABOUR MARKETS KEEP THE PRESSURE ON GLOBAL CENTRAL BANKS

While South Africa's structural challenges are keeping a lid on growth, the country remains sensitive to global economic developments. Recent forecasts from the SARB point to a slight improvement in the global economic outlook as goods inflation has eased and labour markets in major developed countries have remained tight. In the US, unemployment remains near 4% while the labour force participation rate has remained underpinned.

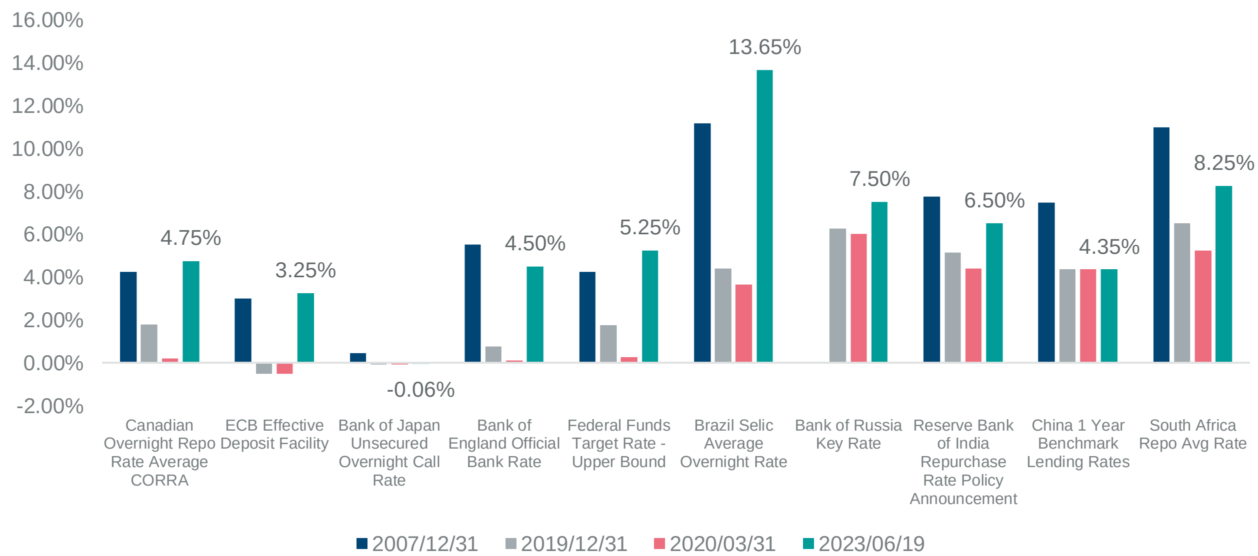
Chart 6: Seasonally adjusted US total unemployment rate and labour force participation rate to end May 2023



Source: Bloomberg

Resilient labour markets across most developed market economies are contributing to still-elevated core inflation (which excludes food and energy prices). For instance, the US core inflation rate for May stood at 5.3% while wage pressures continue to linger, especially in the services sector. Europe and the UK also continue to battle stubbornly high inflation. These dynamics are keeping the pressure on global central banks to raise interest rates. Compared to pre-pandemic and historical levels, policy rates are now in restrictive territory across most of the globe.

Chart 7: Global policy rates as at 19 June 2023 vs historical levels



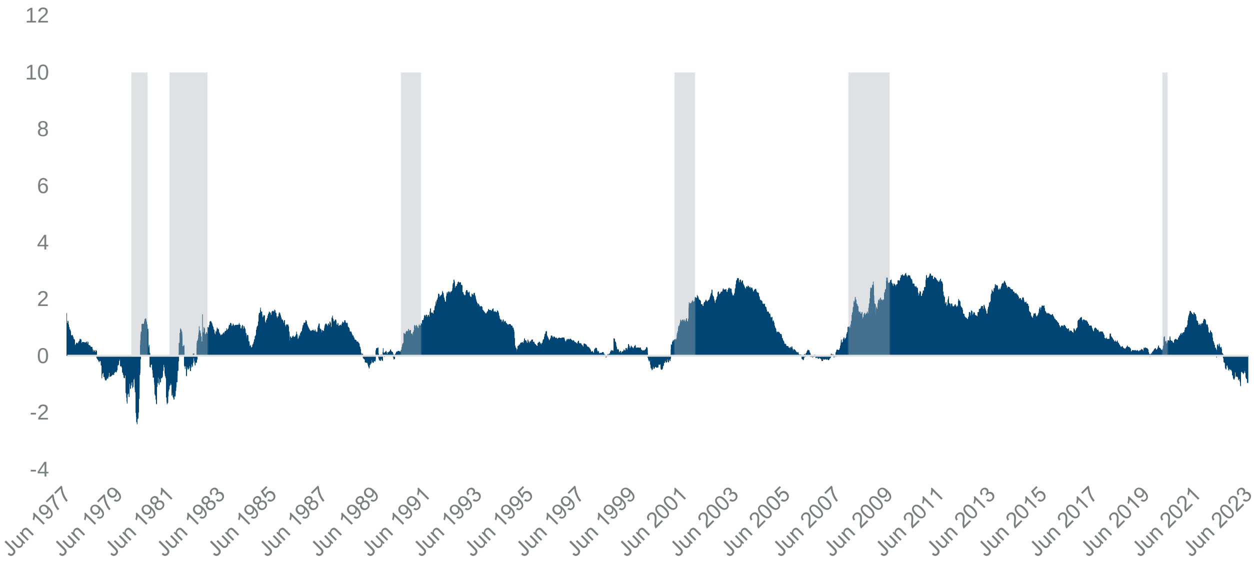
Source: Bloomberg

Although the fight against inflation has seen most global central banks tighten monetary policy, there are a few exceptions, the most notable being China with the People's Bank of China having embarked on new stimulus measures to keep the economy on a growth path of 4–5%. China faces an uneven economic recovery post COVID amid a decline in home sales and manufacturing activity, offsetting the strength in the services sector. It is against this backdrop that the central bank has provided monetary support, diverging from the global trend of tighter monetary policy.

LOOKING AHEAD

Based on traditional indicators, the risk of recession in the US remains elevated. The US yield curve (difference between long- and short-dated yields) is seeing its greatest inversion since the early 1980s, as shown in Chart 8 below. According to the New York Fed, the probability of the US entering a recession (within the next 12 months) increased to 70.85% based on the steepness of the inversion.

Chart 8: 10-year – 2-year US treasury yield spread vs US recession

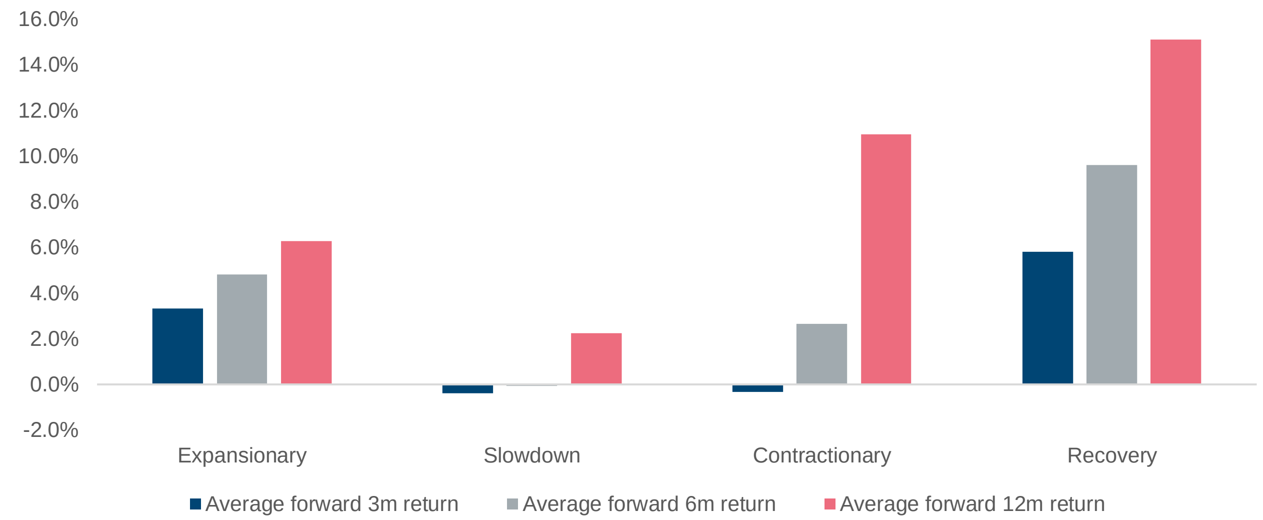


Source: Bloomberg

While the yield curve inversion has been a good predictor of recessions in general, the lead time to a recession may vary significantly and the outlook remains uncertain. The strength of the US consumer is one factor that is keeping the outlook uncertain as pent-up demand from the pandemic and excess savings continue to have an effect, supported by fiscal stimulus over this period. These dynamics continue to support the services industries, creating a divergence between the performance of the services and manufacturing sectors. However, fiscal stimulus programmes are now at risk of being cut or reformed in the wake of the latest debt limit deal which requires the US government to reduce its spending by around $2 trillion over the next 10 years.

With the US central bank expected to keep interest rates high, at least for now, and fiscal support expected to moderate with the new debt ceiling, a contraction in the US economy remains probable, and risks to corporate earnings and returns remain tilted to the downside.

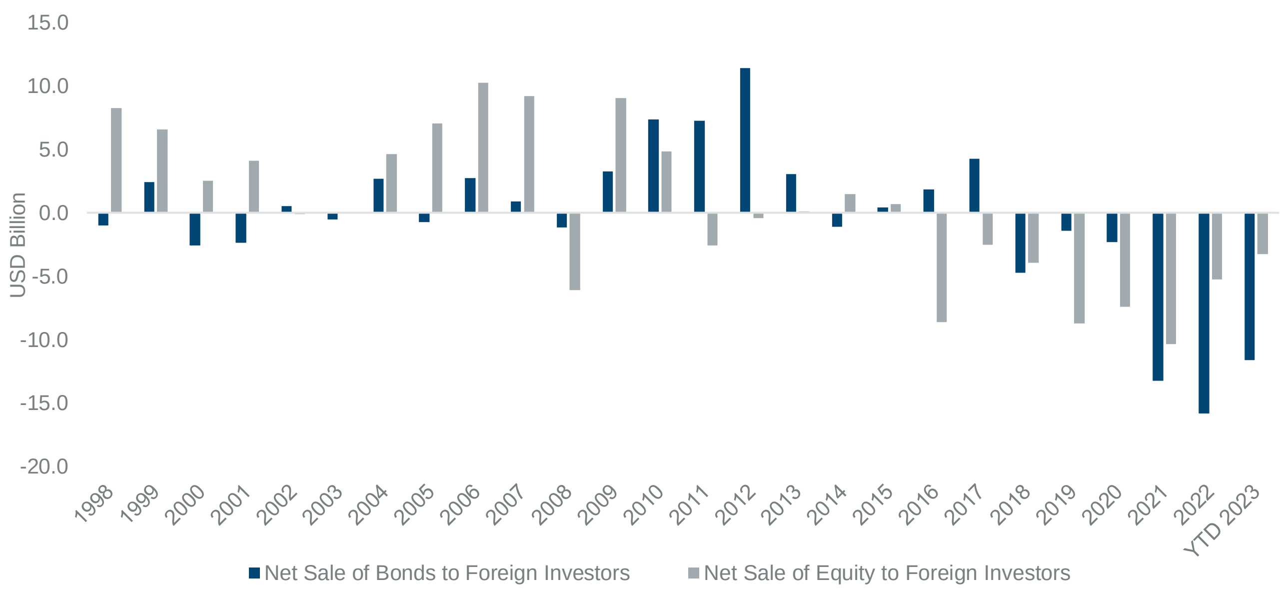
Chart 9: Average forward returns of the S&P 500 over different phases of the business cycle



Source: Bloomberg

On the domestic front, South Africa's economic performance and assets remain hindered by country-specific issues, such as ongoing power constraints, the high unemployment rate, and an imprudent and inconsistent foreign policy in an environment of heightened geopolitical risk. The SARB estimates that loadshedding will shave 2 percentage points off growth this year, with the domestic economy expected to grow by just 0.3% this year. Against this backdrop, foreign investors have remained net sellers of both South African equities and bonds on a year-to-date basis.

Chart 10: Historical and YTD net sales of SA bonds and equity to foreign investors



Source: Bloomberg

Domestic headwinds and a foreign policy that is out of alignment with that of the US (one of South Africa's largest trading partners), set against a backdrop of global recession worries and geopolitical tensions, make SA assets increasingly vulnerable to changes in the global risk appetite and liquidity conditions.

APPENDIX

Financial market performance as at 30 June 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)	1,4%	0,7%	5,9%	19,6%	16,1%	9,6%	9,2%	10,3%
FTSE/JSE Resources 20 Index	-8,2%	-6,4%	-10,5%	2,9%	12,8%	13,7%	15,9%	8,4%
FTSE/JSE Industrials Index	3,7%	3,4%	17,5%	34,2%	14,5%	8,5%	7,4%	10,2%
FTSE/JSE Financials Index	10,1%	5,3%	5,0%	13,6%	19,7%	3,5%	4,3%	7,5%
FTSE/JSE Shareholder Weighted Index (SWIX)	4,0%	1,2%	3,9%	14,0%	12,6%	6,3%	6,2%	8,7%
FTSE/JSE Capped Swix Index (Capped SWIX)	3,8%	1,2%	3,6%	13,5%	15,7%	6,9%	6,0%	8,5%
FTSE/JSE All-Share Top 40 Index	1,1%	0,9%	7,2%	22,2%	16,3%	10,3%	9,9%	10,8%
FTSE/JSE SWIX Top 40 Index	4,1%	1,5%	5,0%	15,6%	11,8%	6,3%	6,3%	8,8%
FTSE/JSE Mid Cap Index	4,2%	-0,2%	-1,2%	7,5%	14,2%	5,3%	3,8%	6,8%
FTSE/JSE Small Cap Index	3,8%	0,5%	1,3%	10,8%	29,8%	8,5%	6,4%	9,0%
FTSE/JSE Listed Property Index (SAPY)	0,9%	0,7%	-4,4%	10,0%	11,3%	-3,5%	-3,6%	1,5%
FTSE/JSE Capped Listed Property Index	0,9%	0,9%	-3,9%	8,8%	10,5%	-6,4%	-6,2%	-0,3%
Local Interest-Bearing Indices								
FTSE/JSE All-Bond Index (ALBI)	4,6%	-1,5%	1,8%	8,2%	7,6%	7,4%	7,9%	7,4%
FTSE/JSE All-Bond Index 1 - 3 years	2,5%	0,5%	2,9%	7,4%	5,5%	7,6%	7,7%	7,4%
FTSE/JSE All-Bond Index 3 - 7 years	3,7%	-0,3%	3,0%	8,1%	6,5%	8,6%	8,7%	8,2%
FTSE/JSE All-Bond Index 7 - 12 years	5,5%	-1,5%	2,8%	10,2%	7,7%	8,2%	8,5%	7,7%
FTSE/JSE All-Bond Index +12 years	4,8%	-2,6%	0,0%	6,3%	8,3%	6,5%	7,3%	7,0%
Inflation Linked Government Bonds (IGOV)	1,2%	-0,8%	0,0%	1,1%	8,7%	5,3%	3,9%	5,3%
Short-Term Fixed Interest Composite Index (SteFi)	0,6%	1,9%	3,7%	6,8%	5,0%	5,8%	6,3%	6,3%
Inflation Index								
Consumer Price Index (1 month lagged)	0,2%	1,6%	2,2%	6,3%	6,0%	4,9%	4,9%	5,2%
International Indices								
MSCI World Index	0,9%	13,5%	27,4%	37,7%	15,7%	16,7%	15,2%	17,3%
MSCI Emerging Market Index	-1,2%	7,1%	16,0%	18,1%	5,4%	7,9%	9,1%	10,1%
FTSE World Government Bond Index (WGBI)	-4,9%	4,1%	12,2%	12,7%	-4,0%	4,3%	1,7%	6,1%
S&P Global Property	-1,6%	6,8%	11,6%	10,9%	5,9%	6,8%	5,4%	10,4%
USA S&P 500	1,4%	15,3%	29,0%	38,2%	17,6%	19,5%	17,5%	20,3%
UK FTSE 100	-1,0%	8,9%	19,7%	31,7%	14,8%	9,5%	9,3%	10,9%
Euro STOXX 50	1,8%	10,5%	33,2%	57,2%	15,3%	13,2%	12,6%	13,2%
Japan Nikkei 225	-0,9%	15,6%	28,9%	39,7%	8,4%	11,5%	12,2%	14,4%
Currency Movement								
Rand/Dollar (R18.85 = 1 Dollar)	-4,4%	5,9%	10,6%	15,8%	2,8%	6,5%	3,6%	6,7%
Rand/Euro (R20.59 = 1 Euro)	-2,4%	6,7%	12,9%	20,6%	1,8%	5,1%	3,4%	4,8%
JPY/Rand (7.66 Japanese Yen = 1 SA Rand)	8,4%	2,5%	-0,6%	-8,2%	7,2%	-1,0%	1,3%	-2,7%
Rand/Pound (R23.95 = 1 Pound)	-2,4%	9,1%	16,3%	20,8%	3,6%	5,7%	2,9%	4,8%

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