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Economic Commentary

July 2022

Perspective and context

Perspective and context are the two greatest tools that equip retirement fund members to deal with developments in financial markets – gaining a perspective of where we are now and what's happening to us, and considering the context of how macroeconomic events are affecting us at present. Both perspective and context are necessary to understand the impact of events in the first half of 2022 on retirement fund savings.

The overarching theme financial markets have had to deal with during the first half of 2022 is high inflation. High inflation resulted in the pullback of share, bond and property prices globally, which in turn affected retirement funds' investment returns.

Inflation refers to the increase in the prices of goods and services purchased by consumers. Consumers' income tends to remain fairly steady or lag inflation, but as prices increase – typically fuel, electricity and food prices – the average consumer's pay cheque does not stretch as far as it used to. Therefore, inflation reduces the value of consumers' income, as the purchasing power of the pay cheque is reduced every year.

Higher inflation, applying the brakes to financial markets

To deal with higher inflation, central banks around the world respond by pushing interest rates up. As interest rates are pushed higher, the cost of borrowing increases for companies and consumers, which in turn has a dampening impact on the growth of demand for goods and services in the economy. As demand for goods and services pulls back, economic growth decreases and, eventually, inflation comes down.

The current problem experienced with inflation

With US inflation having reached 8.5% and South Africa's inflation likely to rise to levels above 7% in 2022, global inflation has reached concerning levels. The target inflation rate in the US is 2% and the target band for inflation in South Africa is between 3% and 6%. In fact, the South African Reserve Bank (SARB) was actually targeting inflation of 4.5% before the pandemic. As inflation has run way above the target levels, central banks such as the US Federal Reserve (the Fed) and the SARB are expected to increase the benchmark fed funds and repo rate to combat rising inflation.

Graph 1: Inflation

The impact of higher interest rates on financial markets

As interest rates are raised, the cost of doing business increases. Most corporates have debt on their balance sheets and as the cost of servicing debt increases, this reduces profitability and the share prices of these corporates, because of lower expected earnings and a higher discount rate. In addition, interest rates that are hiked in one geographic area relative to another have an impact on the flow of capital and the value of exchange rates.

From the above, it is evident that the uncertainty introduced by interest rate hikes to combat global inflation has a pronounced effect on financial markets. The next question then is: Why is inflation currently so high, and for how long is it likely to remain high?

To reflect on high inflation, it is necessary to differentiate between current high prices and the expectation of higher prices in the future. Current high prices are often a temporary phenomenon, whereas the expectation of higher prices in the future fuels higher inflation. The difference is clearly visible in the demand for wage/salary increases. If current high prices are temporary, wage increases won't react, as both employers and labour look through the cycle. On the other hand, if higher prices are not temporary, the demand for higher wage increases becomes much more pronounced with organised labour taking stronger steps in support of its wage demands.

It appears that South Africa is on the cusp of moving to the systemic expectation of higher prices and the wage demands that would necessarily follow.

This has a knock-on effect, and the demand for higher wages on the back of a higher cost of living becomes a self-fulfilling, vicious circle.

Affecting economies worldwide

Essentially, economic real growth projections for 2022 has been cut by 2% p.a. or more for 2022. This takes into account a possible slowdown in economies resulting from higher interest rates as well as the ongoing impact of the Russia/Ukraine war. Global growth is expected to revert to the long-term trend real growth of approximately 3% p.a. In South Africa, economic growth remained robust during the first two quarters of 2022, largely as a result of the ongoing strong performance of the mining and agricultural sectors of the economy, but also because of the value lock-in in the tertiary sectors. It should be noted the current real growth of approximately 2% p.a. is well above trend, and that from 2023 onwards, South Africa is expected to revert to its long-term real growth trend of approximately 1%.

At the same time, policy interest rates have already been increased by 1.5% p.a. in the US and 1.25% p.a. in South Africa. Bond yields in the US reacted sharply as the US 10-year government bond yield briefly rose to as high as 3.48% p.a. In South Africa, the 10-year government bond yield peaked at approximately 10.8%.

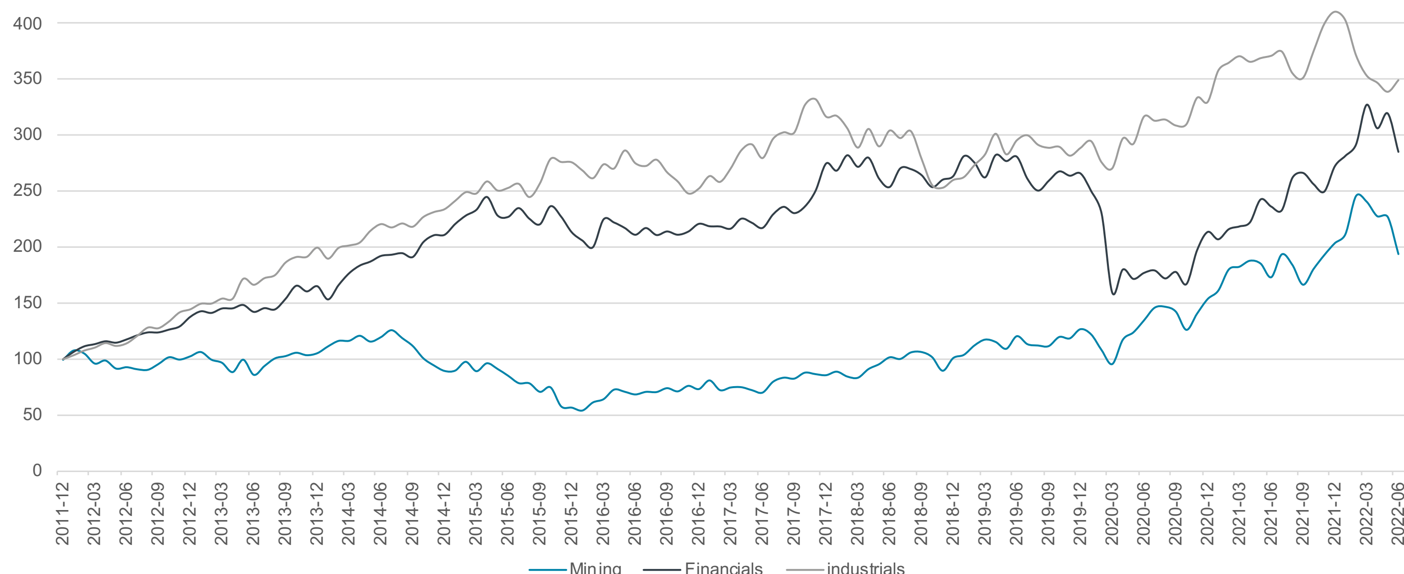
The changes in interest rates impacted the value of exchange rates. The US dollar strengthened to approximately $1.05 against the euro and the rand oscillated between R15.50 and R16.10 to the US dollar.

Graph 2: Exchange rate fluctuations

At the same time, offshore share prices have pulled back since the high levels achieved at the 2021 year-end. Global share prices are down by 23% in USD for the year to date, and in the US, share prices are down by 25% over the same period. Offshore bonds lost approximately 14% in USD over this period.

In South Africa, resources shares on the JSE lost approximately 5% year to date, financial shares gained approximately 5% over the same period, but industrial shares lost 15% despite a strong recovery by Naspers and Prosus in June 2022.

Graph 3: Sectoral contributions to JSE performance (based to 100 in December 2011)



The performance of the major asset classes to June 2022 was as follows:

% change June 2022	Most recent quarter (%)	1 year (p.a.)	3 years (p.a.)	5 years (p.a.)
All Share Index	-11.7%	-8.3%	4.7%	8.9%
Listed Property	-11.6%	-12.7%	0.2%	-8.2%
STeFI Composite	1.2%	2.2%	4.2%	5.3%
BEASSA ALBI	-3.7%	-1.9%	1.3%	6.1%
MSCI All Country World ZAR	-5.8%	-18.3%	-3.4%	12.0%
Barclays Global Aggregate ZAR	2.3%	-11.9%	-3.3%	1.6%
Rand (+ strengthening, - weakening)	-10.3%	-2.1%	-12.4%	-4.5%
Inflation (estimate)	2.0%	3.9%	7.1%	4.9%
Gold ZAR	4.8%	1.4%	16.4%	14.2%

Evaluating the contributions to investment returns for the year to date in 2022, it is clear that perspective and context help to make sense of what has been a difficult period. The current headwinds were not totally unexpected, as economic and financial market variables pointed in that direction, although the extent and ferocity of the correction caught some investors off guard. As financial markets have swung into negative territory, it is important for investors to look through the current negative leg of a typical market cycle. It should be kept in mind that periods of recovery and growth generally follow challenging phases in financial markets.

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12 July 2022

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