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Newsletter

SPEKTRA MAKELAARS

Markets Move Forward

"The stock investor is neither right or wrong because others agreed or disagreed with him; he is right because his facts and analysis are right."

~ Benjamin Graham, The Intelligent Investor

The Economic Resilience to the Russian Invasion

The Russian invasion of Ukraine passed the one-month mark on the 24th of March and global equity markets, to a large extent, appear to have shrugged off the initial bout of volatility brought about by the war. From the 24th of February (the day Russian troops first entered Ukraine) to the end of March global developed markets, as measured by the MSCI World Index are up 6.5% while the US equity market, as measured by the S&P 500, is up 7.3% (both in dollars). In a similar fashion the VIX volatility index, a measure of how much fear and uncertainty there is in the market, has fallen below its long-term average, indicating a drop in market-related anxiety. Our own equity market, as measured by the FTSE/JSE All Share Index, is up 2% since the invasion and up 2% year-to-date.

Currently, South Africa remains a net beneficiary of the war in Ukraine, due primarily to the increase in Platinum Group Metal (PGM) prices over the course of 2022. Together, South Africa and Russia produce the vast majority of global demand for platinum, palladium, and rhodium. With the global superpowers sanctioning Russian exports of commodities, the South African economy has enjoyed the increased demand, and resultant increased prices, for our metal exports.

In a statement by Richard Berner, the first director of the US Treasury's Office of Financial Research, regarding the economic impact of the Russian invasion, he said, "It's a little surprising that nothing has happened so far, but it's early days. There may still be vulnerabilities lurking that aren't immediately evident, and we won't know their nature until shocks expose them. Unfortunately, that's sometimes how it works." At this stage the worst-affected economy from the Russian invasion has been Russia itself. All trading on the Russian stock exchange has been halted and the Russian Rouble has depreciated by over 20% during 2022.

A Bumpy Month for Local Markets

Local markets were rattled during the month of March when Naspers and Prosus, together comprising the largest stocks on the local FTSE/JSE All Share Index, both fell in excess of 20% in three days of trading, dragging the broader index down by 6.5%. The drop came as a result of Chinese tech company Tencent, of which Naspers is the largest external shareholder and is regarded as a local proxy for the foreign company, reporting underwhelming revenue growth for the last quarter.

The decline in revenue growth was largely attributed to the regulatory crackdown introduced in China last year, particularly concerning the areas of technology and gaming. Last year Chinese authorities limited the amount of online gaming allowed for children to three hours per week. Tencent, whose revenues are largely driven by its online games, and who produced eight of the ten most popular online games a few years ago, is being forced to look outward and expand its operations overseas.

The drop in share price was relatively short-lived with both Naspers and Prosus recovering their losses over the next two days of trading. However, both shares ended the month of March in the red. Tencent President Martin Lau has been largely supportive of the regulations instituted by Beijing, stating that they will lead to "healthier growth in the long run." Furthermore, he said that the current gaming challenges should prove temporary in nature and that the company has many new games lined up for release once regulatory uncertainties begin to ease.

From an investment point of view, many local asset managers argue that Naspers and Prosus both trade at significant discounts to fair value, and as such they feature in the top ten holdings across many local unit trust funds. Currently the investment case for both stocks remains intact, however the Chinese regulatory environment requires continual monitoring to assess the impact it will have on investment portfolios.

The Rise of Local and Global Interest Rates

The US Federal Reserve (Fed), in their highly anticipated Policy Meeting in March, elected to raise interest rates to the tune of 0.25%, bringing the federal funds rate to a target range of 0.25% to 0.50%. The move, while not unexpected, did create jitters within the market, particularly as a result of the hawkish tone Federal Reserve Chairman Jerome Powell used in his statements. In a subsequent speech Powell stressed the need to tackle rising inflation head-on, even if it requires raising interest rates to a greater degree than currently anticipated. Powell stated that, “If we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well.” Furthermore, he stated, “The risk is rising that an extended period of high inflation could push longer-term expectations uncomfortably higher, which underscores the need for the committee to move expeditiously.”

US bond markets reacted sharply to the comments, with the US 10-year Treasury Bond yield, a closely-watched indicator of general investor confidence, rising to almost 2.50%, thereby causing a reduction in bond prices and a negative return for US fixed income investments. The next Fed meeting, taking place in May of this year, is currently expected to bring a 0.50% interest rate increase. With inflation in the US currently running at just below 8.0% the real interest rate earned (calculated by subtracting the current inflation rate from the prevailing interest rate) is in significant negative territory. Current expectations are for another seven rake hikes in 2022, with the policy rate reaching a high of 3.0% by the end of 2023.

Locally the SARB also elected to raise interest rates by 0.25% in March, bringing our local repo rate to 4.25% in a move that was largely expected by market participants. What did come as somewhat of a surprise, however, was the opposing views of the monetary policy committee, with two of the five members electing for a more hawkish 0.50% increase. Looking forward, the local repo rate is expected to reach a level of just over 5.0% by the end of 2022, giving the SARB a good degree of margin to raise rates at a moderate and controlled pace, and avoiding the need for aggressive hiking. This will be positive for local equity markets and will reduce the probability of any unexpected shocks to the system as a result of Monetary Policy Committee decisions.

Local inflation figures have come out at 5.7% and are expected to peak at just over 6.0% before returning to more moderate levels. Comparing our inflation figures to those of the US, the current difference between the two inflation rates is just over 2.0% (in our favour), an inflation differential which has only occurred once in the last 50 years. This phenomenon will also give some credence to the recent strength of the Rand, which has been steadily strengthening since November of last year, and is currently trading around 14.50 to the Dollar. Economic theory reasons that when there is an inflation differential between two countries, the country with higher inflation will experience a depreciation in its currency since inflation can be equated with a decrease in a money’s purchasing power. In addition to this, the very strong trade balance that South Africa is exhibiting on the back of higher commodity prices (of which we are net exporters) is another supporting factor of the current Rand strength.

The immediate question at these levels is, “how long can the Rand stay so strong, and when will it start to pull back?”. If the abovementioned factors persist we could see the Rand stay at these low levels for a sustained period. However, history has also taught us that periods of extreme Rand strength, such as we are experiencing now, don’t tend to last for very long…