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# Pivots and pivotal politics

What a difference a datum makes. The recovery in risk assets in October received a fillip in November from the downside surprise in US CPI inflation. Never mind that it was still well above 7.0%, the fact that it undershot the consensus forecast by 20bp brought the Fed pivot back into play.

## Fed pivot meets China reopening

Expectations of an earlier reopening in China lent additional support to metals prices and EM assets. The oil price did not followed suit, however, as inventory rebuilding, the SPR drawdown, no further production cuts from OPEC+ and the $60/bbl price cap on urals have likely been contributing to the downward pressure.

Improving sentiment is a welcome development, but we should acknowledge the interplay between financial conditions and the Fed's setting of monetary policy. Too much easing by way of a weak dollar, strong equity market, and lower credit spreads could offset some of the tightening that the FOMC has pushed through. This could put the pace and durability of the pending disinflation at risk.

## Markets disagree on recession risk

The recent rebound in US equities suggests that the probability of a US recession has declined, but the US yield curve remains firmly inverted and this has historically been a reliable indicator of a sharp growth slowdown or recession. Granted, there is some circularity, as yield curve inversion has recently been driven by falling long-term rates, which in turn has lifted equities. Yet the decline in earnings that should ensue as the recession unfolds during 2023 should put renewed pressure on equities in the medium term.

Given that monetary policy acts with a lag, there is already substantial policy action that is yet to show up in the data. If anything, the US economy has proven rather resilient with a solid, albeit not hot, labour market and reasonable levels on manufacturing and services ISMs. This supports further tightening from the Fed, which means the pivot might be premature.

This resilience seems to support the market's hopes that Fed Chair Powell will be able to engineer a soft landing.

## Liquidity lull a headwind

We also need to look beyond primary monetary policy tightening – the Fed has embarked on quantitative tightening and the withdrawal of liquidity. The retrenchment of liquidity impacts on the US and global economies with a lag, so too on risk assets. This is to some extent reflected in the slower momentum in financial asset growth.

The strong dollar, notwithstanding recent softness, has been a headwind to global growth as weak exchange rates have fuelled inflation pressures and broad-based monetary policy tightening.

The upshot is that leading indicators for global inflation have firmly turned a corner and suggest that disinflation should continue. How quickly and how sustainably inflation returns to target will determine the medium-term path for monetary policy. At this stage, it is difficult to call the all clear on inflation.

### Be careful what you wish for

Reopening in China would be positive for EM growth, particularly for South Africa, but it could also lift commodity prices, which would dilute some of the base effects with regard to disinflation. This could keep short-term developed market interest rates elevated, raising the hurdle rate for investment into riskier assets, including emerging markets. Until it is clear that wage inflation is moving lower, the Fed is likely to sound hawkish. This will reduce the degrees of freedom for emerging market central banks, at least for 1H23.

From South Africa's perspective, the SARB has been firmly focused on the exchange rate, inflation risks, and inflation expectations. Ongoing hikes from the Fed will ensure that the SARB keeps lifting the repo rate, albeit at a slower pace, in a bid to buttress the rand.

### Political turmoil could raise long-term premia

The recent political developments around "Farmgate", impeachment processes, resignations, and recalls have introduced SA-specific risks as we near the end of 2022.

The question for the local market is whether the elevated political uncertainty will be sustained, and how much excess risk premium is warranted. Much of the risk premium would have to come via fiscal pressures as political turbulence further dampens confidence and private sector fixed investment. In addition, a change in leadership could signal a walk back on reforms and greater spending pressures.

This implies that the bullish spillovers from global markets and the growth benefit of an open China could be offset by local politics amid intensifying load shedding. While the rating agencies affirmed their views on the SA sovereign in the November round of updates, it seems that there is still a lot more work to do to lift the trajectory.

## Market developments

Improving risk appetite during November ensured that all of the major local asset classes outperformed cash (0.5%). Equities (9.6%) took the lead, followed by listed property (6.3%), and fixed-rate bonds (3.9%). Inflation-linked bonds (0.6%) were the laggard. The stronger rand (8.2% against the US dollar) would have been dilutive to offshore returns.

### Dollar dampened by CPI data

The downside surprise in US CPI and attendant expectations of a Fed pivot put notable downward pressure on the US dollar in November. The weakness was broad based, with the DXY dollar index losing 5.0% month-on-month. Easing energy strain in Europe and lower natural gas prices gave the euro some reprieve, while sterling recovered on the back of a more credible fiscal plan.

EM FX recovered in November, rising by 3.2%, on average. However, this was dragged down by a weak performance from the Argentine peso (-6.2%). The Brazilian real (-0.2%) was also a laggard due to elevated

political and fiscal concerns, while the Thai baht (8.4%) and South Korean won (8.1%) benefited from the relaxation of some of China's zero-Covid policies.

## Rand shakes off Phala Phala

The rand was also a relative outperformer, gaining 8.2% against the dollar and 4.7% on a trade-weighted basis. The recommendation by the independent panel on the Phala Phala scandal introduced significant uncertainty on the last evening of the month, which escalated in early December amid speculation that Ramaphosa was set to resign.

USD/ZAR spiked to 18.00 but has retraced to 17.30 (at the time of writing). While political uncertainty has most certainly increased, USD/ZAR is trading broadly in line with our 16.50 – 17.50 fair value range.

## Yields rally on soft landing, but inverted curve signals recession

Expectations of stronger disinflation amid a sharp slowdown in the US put downward pressure on US nominal yields and breakeven inflation rates during November. The 10-year UST yield fell by 44bp, to 3.61%, while 10-year breakeven inflation fell to 2.4%. TIPS yields also fell as longer-term monetary policy expectations moderated.

While the Fed funds futures curve is still pricing in a peak Fed funds rate around 5.00%, in line with Powell's guidance during the month, the anticipated 2024-2025 easing cycle has been upgraded from 200bp to 250bp.

## SA lags EM bond market rebound

Lower DM yields, the recovery in commodity prices, and positive risk appetite spurred gains in EM bond markets. The EMBI+ yield rallied by 100bp, while the GBI-EM yield fell by 57bp. Hungary (-185bp) and Poland (-176bp) were the standout performers, while Brazil (87bp) and China (28bp) were the laggards. The former reflected renewed fiscal concerns with Lula's election, while the latter reflected redemptions due to higher borrowing rates and a preference for equities to benefit from faster reopening.

South Africa's bond market posted a middling, albeit solid performance, with the 10-year yield falling by 55bp, to 10.8%. The "Farmgate" news flow triggered a sharp sell-off, with yields spiking to 11.50%. Half of the loss has been retraced, with yields at 11.10% only moderately above our 10.50% - 11.00% fair-value range.

## Equities betting on Powell pivot and a soft landing

Global equities continued to benefit from risk-on, expectations of a Fed pivot and a soft landing, and accelerated reopening in China as select zero-Covid policies were eased. Earnings expectations have moderated, but only marginally, with a recovery expected by the end of 2023.

The S&P500 gained 5.4%, while the Eurostoxx rallied by 8.0% and the FTSE All Share by 6.8%. EM trumped DM in November, with the MSCI Emerging Markets Index surging by 14.8% in US dollar terms, beating a respectable 7.0% gain in the MSCI All World Index. Reopening speculation triggered a sharp rebound in the MSCI China Index (30%), with positive spillovers to regional EMs. The MSCI South Africa Index (19.6%) was a prime beneficiary with the stronger rand further boosting US dollar returns.

The ALSI and SWIX rebounded by 12.3% and 9.6%, respectively, with the bulk of the performance coming from technology (38%) as Naspers and Prosus surged on China easing on its regulatory stance and zero-Covid restrictions. Consumer discretionary (17.3%) and basic materials (16.7%) also outperformed on rebounding commodity prices and better growth expectations. Telco's (5.8%), financials (5.1%), industrials (2.6%), and consumer staples (1.5%) lagged the overall market, but nevertheless printed in the black, while health care (-6.3%) was the laggard.

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