Echoes of 2022

February can be characterised as markets going from Goldilocks to bearish. EM prospects have deteriorated somewhat due to resilience in US growth and inflation that has led to a reassessment of the peak in rates.

Despite the risk-off backdrop, equity markets still seem to think that a recession will be avoided even as the Fed needs to hike further and longer to squash inflation. This is in stark contrast to the US yield curve, which fell to -106bp on the 2-year/10-year yield spread in early March.

The fallout from Silicon Valley Bank's (SVB's) collapse has resulted in renewed curve steepening, but at -70bp the level of inversion still makes recession the bond market's base case. Yet the situation has become even more fluid as the woes in the niche-banking sector have pushed the peak in the Fed funds rate down back to 5.25%.

Liquidity dynamics influence markets

The risk-on backdrop in January was due to renewed liquidity provision in recent months by some countries, which offset quantitative tightening in others. The debt ceiling has resulted in the US government drawing down its deposits with the Fed, which adds to interbank liquidity. A similar phenomenon was at play in Europe in 2H22 and into 2023. The more aggressive intervention by the BoJ to protect its 10-year yield target also added to liquidity, while the PBoC has not only injected liquidity into the banking system, but has also not been sterilising its reserve accumulation.

The positive impact on financial markets was seemingly short lived and is unlikely to be repeated, which means investors must contend with elevated core yields. FX generally fared worse than rates, which could imply further pain for local markets. To be sure, iron ore and the dollar stand out as being the only major "asset classes" to perform well in February.

Echoes of 2022?

If indeed higher US rates reflect better growth prospects, then positive real spillovers should benefit growth-linked exchange rates and bond markets. Rather, strong growth could be underpinning US inflation, which would necessitate higher core real rates for longer, with negative implications for EM growth and asset prices.

This looks similar to what transpired in 2022, but the impact should be less severe. Monetary policy tightening cycles are well advanced in developed economies and peak rates have been reached in many emerging economies. Moreover, there is already substantial risk premia evident across emerging markets, from FX to rates and equities.

Echoes of 2008?

What SVB's demise and the closure of Signature Bank highlight is that monetary policy has inconsistent lags with variable impact. The consequence of policy tightening for SVB was partly indirect via its investment portfolio, where it was forced to realise losses to make good on deposit withdrawals. These deposit withdrawals accelerated, as SVB was unable to raise adequate capital amid a share price collapse.

The Federal Deposit Insurance Corporation (FDIC) has taken control of SVB, but the government has emphasised that there will be no bank bailout. In the 2008 GFC, the US government bailed out banks at taxpayers' expense. This time the Fed has launched a Bank Term Funding Program (BTFP) with a US$25bn backstop from the government. The facility will be in place for a year and banks can access collateralised loans for terms up to twelve months.

Given the extent of the Fed's tightening cycle, which is may or may not be complete given the current systemic concerns, it is reasonable to expect select bank failures, corporate defaults, and risky sovereign debt restructuring. Yet safe haven demand for US Treasuries suggests that investors are concerned about a broader fallout, but regulations and reforms since the GFC should prevent a bank failure such as SVB's from becoming systemic.

Even so, the significant role that SVB played as a deposit-taker in the tech sector has caused reverberations in the US and across the Atlantic. Moreover, it is in keeping with the Fed's historical tendency to blink at the first sign of real trouble. Could this be it?

Global rates, FATF grey listing and Eskom raise SA's cost of doing business

From an SA-perspective, we would have to add another layer of costs to an already challenging backdrop due to the confirmed FATF Grey listing. In addition, the government has effectively taken on R168bn of Eskom's debt in addition to R86bn worth of interest expenses. While this falls "below the line" in terms of budget accounting, it adds to the government's debt burden and interest bill.

Government declared a national state of disaster in response to the electricity crisis, yet not much has been done to remedy the situation. Load shedding has oscillated between stage 2 and stage 6 year-to-date, which very likely implies SA is in technical recession given the 1.3% contraction in GDP in 4Q22. In addition, a state of disaster was declared to deal with widespread flooding in the northern parts of the country.

It never rains but it pours.

SARB on track for another hike, but cycle should be nearly done

Good rains should help ease food price pressures, but the electricity shortage has had a stronger impact. Due to higher input costs and supply disruptions, food price inflation has risen to almost 14%. Add in the prospect the La Nina (which usually means good rains for SA) will shift to El Nino (which could mean drought for SA) over the course of the year, food price disinflation could be notably less than initially thought.

Despite depressed growth, elevated inflation and a hawkish Fed should make it difficult for the SARB to call the all clear on hikes now. While we expect another 25bp hike at the March MPC meeting, an SVB-induced Fed pause in March could throw the doves amongst the hawks when the MPC meets on 30 March to deliberate on the local policy stance.

Market developments

Gains were sparse in February with only cash (0.5%) and inflation-linked bonds (0.5%) ending in the black. Equities (-2.3%) underperformed, followed by fixed-rate bonds (-0.9%) and listed property (-0.7%). The 4.9% depreciation in the rand versus the US dollar would have been accretive to offshore returns.

US data puts dollar on the front foot

The dollar DXY index rose by 2.7% in February amid the re-pricing in Fed expectations as growth and inflation releases surprised to the upside. Despite renewed US exceptionalism, the greenback's recovery in February was muted compared to its 10.4% decline since early November.

With the bulk of the Fed's tightening cycle in the base, it will be difficult for the dollar to repeat its strong 2022 performance in the absence of another large geopolitical shock.

Rand roiled in part by rising SA risk premium

Even so, EM FX had a tough time in February with only the Mexican peso (2.6%), Peruvian sol (1.4%), and Hungarian forint (0.9%) appreciating against the dollar. The rand was a relative underperformer. Based on the 3.5% decline in the rand's trade-weighted index, SA-specific factors also dampened the currency.

The rand's undervaluation may reflect risk premium associated with power cuts, the Grey listing, a weak growth outlook, and a deterioration in the current account balance.

US yields elevated, breakeven inflation compressed

Global rates markets reversed sharply as “Goldilocks” was priced out and “no landing” was priced in. The US 10-year yield rose to almost 4.0% with two thirds of the rise due to higher real yields. Break-even inflation was only slightly wider, which suggests that either the Fed is wrong on being overly hawkish given that inflation will crater, or the market is under-pricing the risk of inflation persistence.

SA bonds underperform despite budget holding the line on issuance

Either way, EM markets had to contend with a higher cost of global capital. EM local yields rose by 27bp, on average, with Turkey the only major EM market to rally in February. SA was the standout underperformer, with the benchmark 10-year yield rising by 85bp, albeit off an overvalued base.

This aligns with a larger SA-specific risk premium relative to peers, rather than purely being a function of the more adverse global financing backdrop. On balance, the 10-year yield at 10.75% is aligned with our 10.50% - 11.00% fair-value range.

Following net foreign buying of R29.2bn in January, non-resident appetite for SA bonds soured, with net selling of R25.3bn in February. The bulk of the outflows were in the sub-10 year area of the curve, which contributed to the bear flattening seen over February. Net foreign disinvestment was largely offset by inflows from the domestic unit trust industry.

Non-resident holdings of government debt declined to 25.4%, which is to the level in December 2022 and early 2011.

Muted equity sell-off in the broader context

While generally weaker, DM equities held up well relative to the losses on FX and rates. The S&P500 declined by 2.6%, but the Eurostoxx and FTSE All Share Index gained 1.9% and 1.1%, respectively. The MSCI World Index declined by 2.4%, outperforming the MSCI Emerging Market Index, which lost 6.5%.

While the bulk of EM bourses were weaker, the underlying performance was wide-ranging, with the MSCI Czech Index up 10.4% and the MSCI Colombia Index down 16.3%. The MSCI South Africa index declined by a below-average 8.1%. The weakness in EM was in part due to exchange rate depreciation, but belies the notion that growth is rosy all round.

SA equities down on waning China/commodity price support

The ALSI and SWIX lost 2.2% and 2.3%, respectively in February. Basic materials (-12.7%) and technology (-2.9%) were the major drags on the market amid weaker commodity prices and an underwhelming China reopening (relative to what was priced in). In addition, domestic energy constraints and higher input cost added to the pressure on commodity counters. Consumer discretionary (3.8%), consumer staples (3.1%), health care (2.4%), financials (2.3%), and telco's (1.6%) posted reasonable gains, while industrials (0.4%) eked into positive territory on the back of better performance in the transport, services and construction sectors.

The equity market re-rated marginally to 11 times, but this still reflects a discount versus history and peers. There were modest downward revisions to earnings, particularly in basic materials.

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