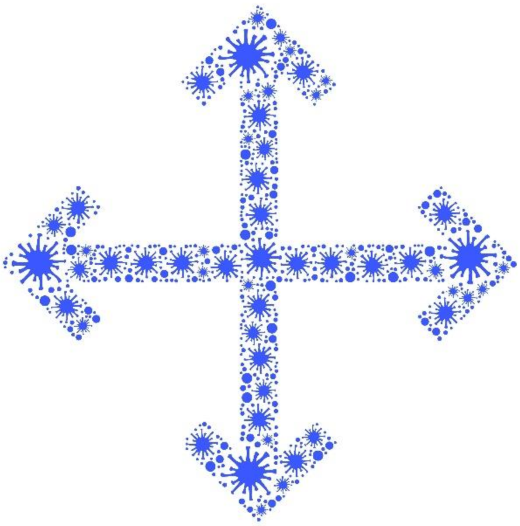

Monetary policy and mutations

Turbulent is probably the best way to describe November. Reaccelerating growth, persistent bottlenecks, monetary policy flip-flopping, and the discovery of a new Covid-19 variant caused notable intra-month financial market volatility. “Black Friday” extended to financial markets with bargains galore as the news of Omicron hit the wires.

Fed follows through

The Fed announced the tapering of its asset purchases at the November FOMC meeting at the expected pace of US$10bn in US Treasury securities and US$5bn in Mortgage Backed Securities (MBS). Moreover, officials acknowledged that inflationary pressures have been more persistent, warranting a reduction in policy accommodation.

US growth and inflation surprises stand out, with this exceptionalism lifting the Fed fund futures curve and supporting the US dollar. The FOMC minutes and subsequent comments from Fed Chair (and nominee) Powell signalled a faster pace of tapering might be needed. This prompted the market to quickly shift expectations to Fed funds lift-off in 2Q22 and analysts to double the expected pace of tapering.

In contrast to the Fed following through on its guidance, the BoE had flipped more hawkish over the course of Q3 only to flop in November by not hiking interest rates (with a 7:2 vote in favour of no change). The ECB remains dovish, but ready to act if the inflationary surge proves more persistent. For now, the focus is on the Fed in setting global monetary policy conditions.

Pretoria, we have lift-off!

With small open economies being price takers on global financing conditions, the SARB’s decision to hike rates in November was at least partly due to EM peers being well into their hiking cycles, as well as uncertainty about the spillovers from the Fed taper and lift-off. The terms of trade, current account surplus, and profits growth are all most likely past their peaks, with a loss in momentum posing downside risk to the rand and local growth. This creates a trade-off for the MPC, as reflected in the close (3:2) vote for a hike.

At this stage, potential vulnerabilities to the rand and attendant inflation risks will take precedence over growth. This is particularly the case if growth is being constrained by factors not associated with the SARB’s stance– notably Omicron and load shedding. It is plausible that the vaccine rollout will negate the need (or preference) for severe restrictions over the year-end holiday season. This would also make the Bank less focused on historical GDP outcomes, with a case in point the Q3 contraction that was largely due to the social unrest and alert level 4 lockdown.

Still a challenging sovereign rating outlook

The local government elections and Medium Term Budget Policy Statement (MTBPS) both went off relatively smoothly. The ANC fell to below 50%, as experts were predicting, giving rise to the age of coalitions and a true test for the effectiveness of bargained councils. The mini-budget was almost a non-event in its prudence. However, with a widening employment gap at the lower end of the wage spectrum, pressure continues to mount for the government to implement a basic income or unemployment grant. As such, the February Budget will be the toughest balancing act yet.

Despite the improvement in the cyclical fiscal position and some token reforms, S&P and Moody's kept their respective ratings and outlooks on the SA sovereign unchanged in November. It is still hard to see how we turn the corner on the sovereign credit rating given structurally low growth.

Hiking just to stand still

Surging Covid cases in the Eurozone and the discovery of a new, more contagious but potentially less virulent variant – Omicron – have caused consternation of another growth slowdown and stagflation, but policy makers continue to be led by inflation outcomes.

Broadening restrictions in the Eurozone and the knee-jerk travel ban on select Omicron-infected countries pose downside risk to Q4 momentum. Yet central banks are still scrambling to keep pace with rising inflation. Despite rate hikes in New Zealand, Hungary, Czech Republic, Poland, Russia, South Korea, Mexico, Chile, Peru, and South Africa, real policy rates are at best stable or lower, delivering a form of stealth easing. This inability (or unwillingness - certainly in the case of Turkey) to protect real rate differentials is evident in EM FX underperformance this year.

Yet, it is a stark reminder that for all the focus on Fed "hawkishness", the real policy rate in the US is sitting at -6.0% and the real 10-year yield at -4.8%! True normalisation would be a gargantuan test for risk assets, but the debt overhang will probably prevent this.

Market developments

During November, equities (4.5%) and listed property (2.2%) outperformed by a wide margin, with fixed-rate bonds (0.7%) only marginally beating cash (0.3%). Inflation-linked bonds (-0.1%) underperformed, while the 4.6% decline in the rand versus the US dollar would have enhanced offshore returns.

Don't doubt the dollar

The dollar index (DXY) gained 2.0% in November, supported by a more hawkish Fed, upside US activity surprises, and heightened risk aversion. The risk-off backdrop was evident in the Japanese yen's gain of 0.7%, as all the other G10 currencies weakened. EM FX had a tough month, losing 3.4%, on average, against the greenback. EMEA fared the worst, down 7.6%, on average, as Turkey's currency crisis intensified and the lira cratered by 29%. The rand was the third worst performing EM currency in our universe, losing 4.6% against the dollar. Even so, it tracks in the middle of the pack on a year-to-date basis.

With USD/ZAR at 15.80, the rand is trading cheap on our 14.50 – 15.50 medium-term fair-value range, but there are building headwinds in the form of a receding current account surplus, lower commodity prices, and sharply slowing growth. Monetary policy tightening should provide a partial buffer.

USTs banking on Fed credibility

As an example of “buy the rumour, sell the fact”, US yields fell in the wake of the November MPC meeting, which confirmed the much anticipated Fed taper. This rally was in part due to modestly lower oil prices as the US attempted a co-ordinated release of strategic petroleum reserves. This reprieve was short-lived with US CPI inflation above 6.0% pushing breakeven inflation sharply higher.

More hawkish Fed rhetoric regarding a faster pace of taper led to a decline in breakeven inflation and flattening in the yield curve as hiking expectations were brought forward. Growth fears from the Omicron variant, the release from the strategic petroleum reserves, and OPEC’s announcement of higher production from January added to the pressure, as oil tumbled from US$82/bbl to US$70/bbl over only three days.

With the Fed funds futures pricing in the first hike for 2Q22, the bond market has become more concerned about a growth slowdown. Yet the policy focus remains on upside inflation risk, with Fed tightening presenting a more adverse financing backdrop for emerging markets.

SA bonds cheap, but bullish catalysts still absent

While the GBI-EM yield rose by only 14bp, it masks varied underlying country performances. Turkey’s 10-year yield rose by 83bp, while Brazil’s rallied by 92bp. South Africa’s 5bp increase masked notable intra-month volatility, with the bond market performing well into the MTBPS only to reverse course on global inflation and hiking fears, culminating in the risk-off spike on “Omicron Friday”. At 9.90%, the local 10-year yield screens cheap versus our 9.00% - 9.50% fair-value range, but the absence of non-resident sponsorship and limited scope for further issuance cuts will limit gains.

The Treasury’s bond holdings data shows that the share of non-resident holdings ticked lower to 28.2%, with net buying of only R0.6bn during November. The bulk of the net issuance was taken up by CIS funds, given that SA bonds continue to screen very cheap compared to other asset classes.

Omicron was ominous for equities

Following the strong rebound in global equities in October, markets traded sideways for much of November. The hawkish Fed, US debt ceiling uncertainty, broadening inflationary pressures, and the high oil price, triggered concerns about the sustainability of earnings growth and ratings. The news flow on Omicron triggered month-end losses for most markets; the S&P 500 lost 0.8% while the Eurostoxx slumped by 3.3%.

Underlying weakness and the stronger US dollar left the bulk of the MSCI country indices lower. The MSCI EM Index (-4.1%) underperformed the MSCI World Index (-2.2%). Gains were limited to Chile (6.0%), Philippines (2.6%), and Czech Republic (0.3%), with Argentina (-16.5%), Turkey (-13.4%), and Poland (-11.7%) the notable laggards.

The MSCI South Africa Index declined by 4.5%, which largely reflected the weaker rand. The ALSI gained 4.5%, while the SWIX posted a modest total return of 0.7%.

The sector performances were again wide ranging. Consumer Discretionary (19.0%) outperformed, reflecting the large gains in Richemont, followed by Telco’s (11.0%), and Basic Materials (6.8%), which was boosted by gold counters. Health Care (-5.5%), Technology (-4.1%), Industrials (-1.9%), Financials (-1.9%), and Consumer Staples (-1.6%) underperformed.

The November gains coupled with broadening negative earnings revisions enabled a modest re-rating in the market. Even so, at around 10x the forward PE ratio reflects a 25% discount versus the long-run average.

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