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Time will tell

The supposed Fed pivot following the downside surprise in the July CPI report and the less hawkish take on the July FOMC was short-lived, as risk appetite waned in August. This reversed the bear market rally in equities amid a surging US dollar. In turn, financial conditions tightened sharply, which is part of the Fed's requirement to help get inflation under control.

Adjusting policy peaks

As such, Fed Chair Powell's short and sharp comments at Jackson Hole were a success, with the Fed funds futures curve pricing in a peak of 4.0% by the end of August and pushing out the potential for rate cuts well into the second half of 2023. Following the upside surprise, albeit marginal, in the August US CPI report, the market has turned even more aggressive, with a peak policy rate at 4.5%.

The ECB also signalled a more hawkish stance amid the war-related energy price shock. Analysts rapidly adjusted their expectations for the September ECB meeting to a 75bp hike, off a 0% deposit rate base, which Lagarde duly delivered. The BoE is concerned about a loss of confidence in the pound, which has also triggered shifting expectations for a higher terminal rate, at around 4.75%. So far, these expectations have done little to stem the US dollar, which in turn is tightening the screws on EM growth.

Long-term inflation risks at the core

While a Q3 reacceleration in global growth seems to be underway, expectations for resilience have been waning. DM housing markets are under significant pressure, alongside ongoing energy supply disruptions and lockdowns due to China's zero-Covid policy.

While leading price indicators suggest that global inflation is peaking, there is uncertainty about the level at which inflation will ultimately settle. Moreover, core metrics are at risk of remaining sticky due to the large share of services, strong wage growth, lower productivity, and high rental inflation. Many central bankers are fretting about a wage-price spiral.

Rand adding to SARB concerns

Locally the SARB has become more vocal on the same topic due to the rise in surveyed inflation expectations, higher breakeven inflation, and wage settlements above 6.0%. While MPC members are reluctant to give explicit forward guidance, we know a myriad of factors inform their decisions. Most notable will be the pace of Fed tightening and impact on the rand.

On this front, the news is not necessarily as disconcerting as headlines would suggest. While the rand is 17% weaker versus the dollar since end-Q1, it has lost roughly half that on a trade-weighted basis. So yes, there is significant risk of exchange-rate pass-through to inflation, but this could be less than feared given the trade linkages with Europe and China where FX pressures have also been building. Moreover, Q3 should

mark the cyclical peak in headline inflation, which might give the SARB more comfort in easing off the pace of hikes.

Too soon to call the all clear

Unfortunately, the global backdrop is fluid and uncertain, making it too early to call the all clear on inflation and monetary policy tightening. Even if South Africa is proving somewhat resilient, there is a lot of tightening in the system that is yet to impact on activity. Next year is set to be even tougher than this year amid the highly likely FTAF grey-listing and ongoing load shedding, but first we need to navigate the rising political uncertainty.

Market developments

During August, inflation-linked bonds (2.5%) were the only major domestic asset class to beat cash (0.5%). Fixed-rate bonds (0.3%) eked out a marginal gain amid wide ranges, while equities (-1.3%) and listed property (-5.4%) ended the month in the red. The rand lost 2.8% against the dollar, which would have been accretive to returns from offshore allocations.

The dollar is the dearest

The DXY dollar index rallied by 2.6% in August, with gains broadly based against the DM currencies. The yen, sterling, and euro faced ongoing strain as the Fed renewed its commitment to fight inflation, while the energy shock in Europe had negative spillovers. EM FX showed some resilience, losing only 1.0% against the greenback, on average.

The rand was a relative underperformer as global growth concerns, commodity price support, and downside surprise in China activity data ultimately weighed on the unit. USD/ZAR traded in a wide 16.11/17.14 range, ending the month above 17.00. USD/ZAR is trading cheap versus the fundamental fair value of around 16.00 – 17.00.

Rising yields, recessionary curve

After falling to 2.58% on 1 August, the US 10-year yield steadily rose to end the month at 3.20%. The upward pressure stemmed from rising real rates, as inflation expectations eased thanks to lower fuel prices, as well as the more hawkish Fed. The 2s/10s curve remained inverted throughout the month, and fell to a low of -49bp. Higher US yields were more of a headwind for dollar-denominated EM bonds than for local currency bonds. The EMBI+ yield rose by 36bp in August versus the 5bp increase in the GBI-EM yield. The latter masked a wide underlying performance with Hungary selling off by 71bp while Brazil rallied by 69bp.

South Africa’s 10-year benchmark yield rose a net 12bp in August, but this belies a round trip from 10.78%, down to 10.35%, and back to 10.89%. In contrast to nominal yields, as well as the ascent in US TIPS yields, local inflation-linked bond yields rallied sharply in August amid heightened inflation concerns. This pushed breakeven-inflation 50bp wider and well in excess of the 6.0% target upper limit. While the local curve reflects a substantial “excess” risk premium, tactically the market is only marginally cheap given elevated uncertainty around the Fed and quantitative tightening.

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Equities creaking again

The bear-market rally petered out in August, with equities reversing course quite sharply. The S&P500 lost 4.2%, while the Eurostoxx was down by 5.1%. The MSCI World Index (-4.2%) underperformed the MSCI Emerging Market Index (0.4%) amid notable dollar strength. Eurozone and CEE economies dragged global equity markets lower due to energy supply and price shocks, while hawkish central banks and resilient domestic demand aided the likes of Brazil and India. South Africa was a relative underperformer, with the MSCI South Africa index losing 4.1%.

The ALSI declined by 1.8% and the SWIX by 1.3% on a total return basis. The underlying sector performance was disparate, reflecting a combination of high earnings expectations, lower commodity prices, higher bond yields, and sector specific M&A news flow. On the latter, Walmart's bid to acquire the remaining shares in Massmart lifted consumer staples (4.8%), while technology (1.5%) and health care (1.1%) were the only other sectors to end the month in the black. Consumer discretionary (-0.9%), financials (-2.5%) and industrials (-2.8%) were moderately lower. The weakness in basic materials (-4.7%) was broad based, reflecting lower commodity prices, while telco's (-9.0%) lagged the market by a wide margin.

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