The Monthly Bulletin
SygniaSygnals
October 2023

Prof. Bhorat's column this month: You've likely seen numerous rates of return graphs and tables. But, have you seen a meticulous computation of the real return on all major asset classes since 1870? We hadn't until recently…

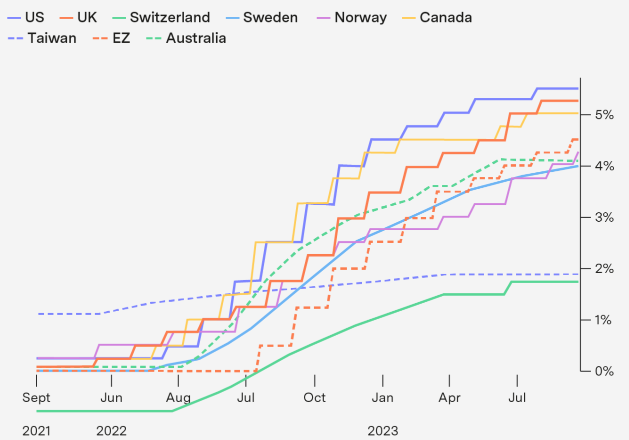
Discover the astonishing results of an analysis spanning all assets in advanced economies from 1870–2015.

Market review

By Kyle Hulett
Co-Head: Investments

September was a month of further market pressure as oil prices rose to a 10-month high, raising concerns that an energy price shock will weigh on growth. Nonetheless, the Organisation for Economic Co-operation and Development raised its global growth forecast for this year to 3.0% from 2.7% in June in its Economic Outlook report, noting that the global economy is set for a slowdown in 2024 as interest rates weigh on economic activity and China's rebound disappoints. Central bank announcements continued to diverge based on differences in underlying growth and inflation: China cut its reserve requirement ratio by 0.25%, in line with its incremental easing policy, while the European Central Bank (ECB) raised rates by 0.25% to a 22-year high of 4.5%, the US kept rates flat as expected, and Japan similarly kept its negative interest rate and the parameters of its yield curve control program unchanged. Developed market central banks are ready to converge at a higher-for-longer outlook. The Bank of England's chief economist, Huw Pill, called this the "Table Mountain" scenario, saying that rates will reach a long plateau at elevated levels, in line with the wide, flat summit of Cape Town's icon Table Mountain. Bond yields rose to reflect the new view and markets came under further pressure. The G20 Summit 2023 took place with little consensus on significant agenda items beyond climate change. Members agreed to triple global renewable energy capacity by 2030 and to provide $4 trillion a year to finance the green energy transition.

Chart 1: Developed world central banks reaching a "Table Mountain" outlook



Source: Bloomberg

The lack of agreement on other matters is not surprising given the rise in geopolitical risks. The word "geopolitics" is being used more often on earnings calls and corporate filings from the world's biggest companies – the flow of fixed direct investment (FDI) backs this trend, with the value of FDI to countries that voted to condemn Russia surging as FDIs to countries that abstained have fallen.

It was a big month for Apple, the largest company in the MSCI World index, as it unveiled the new iPhone 15. But China stole the limelight, first with the launch of the Huawei Mate 60 Pro, which has faster download speeds than Apple's iPhone, and then through its announcement that government employees may be banned from using iPhones due to security concerns. The news led to Apple's market cap losing $200 billion. Meanwhile, Google's long-awaited anti-trust trial in Washington DC began over allegations that it has illegally maintained a monopoly in the online search business and Amazon has been sued by the US Federal Trade Commission for monopolising the online marketplace. Overall, tech stocks remained under pressure during the month due to high, rising US bond yields.

US – Inflation higher for longer

- The US faces the possibility of a mid-2024 recession and prolonged high inflation, prompting the Fed to consider extending higher interest rates to manage inflation targets.
- While labour market recovery is vital for controlling inflation, the Fed anticipates persistent inflation despite the potential easing of job market pressures.

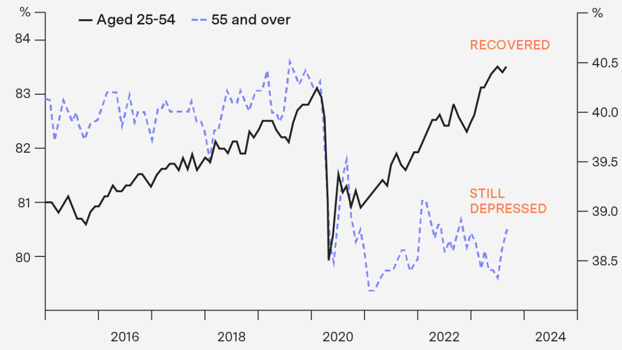
US retail sales beat expectations in September, confirming that the consumer is still resilient. However, a number of factors support the expectation of a recession in the middle of 2024. First, the US is not experiencing any nominal credit growth due to tight lending standards. Second, high US mortgage rates have frozen the market for existing homes. Third, households have depleted nearly all the excess savings accumulated from a combination of government handouts and restrained spending during the pandemic.

This slowdown, together with faster-falling shelter inflation, will see inflation continue to normalise and allow the Fed to stop hiking rates as growth slows. As predicted, shelter's contribution to monthly CPI went from being the highest last month to being considerably lower this month, but transport's contribution cancelled this out by being the largest contributor for the month. The net effect was an increase in monthly headline inflation, which is largely in line with expectations. As anticipated, the Fed kept rates flat at their September meeting, but they raised the prospect of keeping rates higher for longer. Fed Chair Jerome Powell commented that the Fed needs to get to a "place where we are confident we can bring inflation down to 2% over time".

Treasury 10-year yields hit their highest levels since 2007 as investors adjusted to this view. According to a recent Chicago Fed study, the lagged effects of higher interest rates will reduce real GDP by 3 percentage points (pp) over the next five quarters and will be enough to bring inflation back close to the Fed's target by the middle of 2024 while avoiding a recession.

The labour market is key to the wage-inflation outlook. A large drop in the US labour force participation rate during Covid was a key driver of tight labour market conditions, but the prime age-participation rate (25 to 54) has been steadily recovering and is now above its pre-pandemic level. This has lifted the total labour force participation rate to 62.8% – only 0.5pp below its peak. However, the participation rate among the 55+ cohort is still well below pre-Covid levels. A return of the 55+s to the labour force will help ease the job market and avoid a second wave of inflation. The Fed is not betting on that, however, and has acknowledged that inflation is going to be a lot stickier.

Chart 2: Labour force participation recovered for prime age cohort



Source: BCA

145 Years of Returns: A Comprehensive Snapshot

Table 1: Global real rate of returns on all assets, advanced economies: 1870–2015

	Real returns				Nominal returns			
	Bills	Bonds	Equity	Housing	Bills	Bonds	Equity	Housing
Full sample								
Mean return p.a.	1.03	2.53	6.88	7.06	4.58	6.06	10.65	11.00
Standard deviation	6.00	10.69	21.79	9.93	3.32	8.88	22.55	10.64
Geometric mean	0.83	1.97	4.66	6.62	4.53	5.71	8.49	10.53
Mean excess return p.a.	–	1.51	5.85	6.03				
Standard deviation	–	8.36	21.27	9.80				
Geometric mean	–	1.18	3.77	5.60				
Observations	1767	1767	1767	1767	1767	1767	1767	1767
Post-1950:								
Mean return p.a.	0.88	2.79	8.30	7.42	5.39	7.30	12.97	12.27
Standard deviation	3.42	9.94	24.21	8.87	4.03	9.81	25.03	10.14
Geometric mean	0.82	2.32	5.56	7.08	5.31	6.88	10.26	11.85
Mean excess return p.a.	–	1.91	7.42	6.54				
Standard deviation	–	9.21	23.78	9.17				
Geometric mean	–	1.51	4.79	6.18				
Observations	1022	1022	1022	1022	1022	1022	1022	1022

Source: Òscar Jordà, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick & Alan M Taylor, 2019. The rate of return on everything, 1870–2015, The Quarterly Journal of Economics, 134(3): 1225–1298.
Notes: 1. Country coverage: Country coverage includes Australia, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK, USA. 2. Annual global returns in 16 countries, equally weighted. Period coverage differs across countries. Consistent coverage within countries: Each country-year observation used to compute the statistics in this table has data for all four asset returns. Excess returns are computed relative to bills.

By Professor Haroon Bhorat
Investment Committee Advisor

You have no doubt seen many, many rates of return graphs and tables over the years. But have you ever seen a careful, comprehensive computation of the real return on all major asset classes since 1870? I certainly hadn't until very recently. Through very careful, meticulous research, the authors tell a tale of returns in advanced economies on "bills" – namely fixed-income government securities – relative to bonds, equities and housing since 1870, for close to 150 years. This is the first time such an analysis has been done, and for their efforts the authors were published in the world's top economics journals! So what are some of the takeaways here? A key novel finding is that residential real estate over the last almost 150 years – not equities – has been the best long-term investment in modern history. Where housing provided a return of 7.1%, equities provided a real return of 6.9%. Moreover, the volatility of housing returns is substantially lower (10% for housing versus 22% for equities). Using compounded returns (the geometric mean), the returns on housing are even larger relative to equities. The results are stronger for the post-1950 period.

The volatility in equity returns is detailed in the paper, but in summary, equity returns have experienced many pronounced global boom–bust cycles – many more than housing returns – with average high real returns over 16% and as low as –4% over decades. Equity returns fell in WWII, boomed during post-war reconstruction, and fell off again in the general macroeconomic instability of the 1970s. They bounced after a wave of deregulation and privatisation in the 1980s, but then came the Global Financial Crisis… and so it goes on! By comparison, housing returns have remained remarkably stable over most of the post-WWII period, hardly ever breaching a narrow 4–6% real return band.

So there you have it – the rate of return on everything! Stock market enthusiasts will have noticed that the results appear to contradict one of the basic tenets of modern valuation models: that higher risks should come with higher rewards.

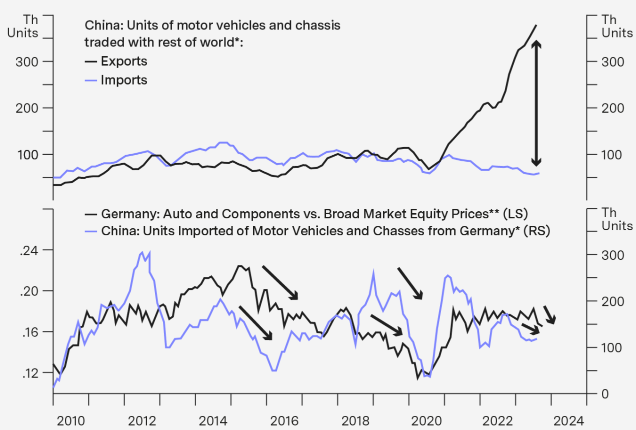
EU – Cannot afford a trade war with China

- Elevated oil prices and a potential US autoworker strike pose additional inflationary risks and uncertainties in metal prices on the global stage.
- The eurozone faces economic strain, balancing a weakened euro and tensions with China over automotive trade while managing inflation and growth.

ECB President Christine Lagarde talked tough on inflation at the ECB's August meeting, but the euro has weakened 5% versus the dollar since July. The ECB is in a tough spot, needing to raise interest rates to combat inflation while simultaneously taking care not to stifle already sluggish economic growth. Tightening domestic credit conditions and export-driven weakness as a result of low demand from China are leading to lower growth in the eurozone.

Germany's central bank warned companies to reduce their dependence on China, with the Bundesbank saying 29 per cent of German companies import essential parts from China, thereby exposing their operations to risk should trade be disrupted as a result of "increasing geopolitical tensions". European Commission President Ursula von der Leyen has called for tariffs to be imposed on Chinese electric vehicles (EVs), arguing that they are being sold at "artificially low" prices as a result of government subsidies. China is the world's largest producer of EVs, and its exports to Europe have been growing rapidly. This has put pressure on European automakers, who are struggling to compete with China on price. China is a big destination for German carmakers, with BMW, Porsche, VW and Mercedes all generating between 20% and 35% of their earnings before interest, taxes, depreciation and amortisation from China – so a trade war may not be in Europe's best interests. Market share for German carmakers in China has dropped from 24.6% in 2019 to 19.1%, while German imports of Chinese vehicles have surged by 57% year-on-year. Von der Leyen has proposed a 27% tariff on Chinese EVs, similar to the tariffs imposed by the US, but China has threatened to retaliate with tariffs on European goods, including cars and luxury goods. Given the strong trade connection with China, aggressive action will harm both parties.

Chart 3: China vehicle exports to the rest of the world have surged



* Shown as a 6-month moving average
Source: BCA

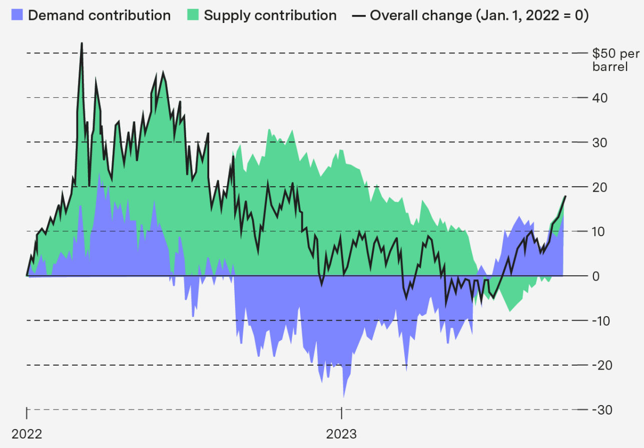
Oil outlook – Oil rise a risk to global inflation

The International Energy Agency (IEA) stated that the world is at "the beginning of the end" of the fossil fuel era. For the first time, the IEA has forecast that demand for oil, natural gas and coal will all peak before 2030. A key driver of the transition to clean energy is China, who has become the world's largest EV market due to its cheap EV batteries. Its EV sales and adoption are expected to continue to grow rapidly in the coming years, and the IEA forecasts that China will reach peak gasoline demand in 2025. This would have a huge impact on the oil market, as China is the world's largest oil importer.

> "Global growth could be 0.5% lower over the next two quarters if prices remain at these elevated levels, and there is scope for oil prices to continue rising – which is a risk for global inflation."

In the short term, oil prices are likely to remain elevated. After falling by 12.0% in the first six months of the year, the price of oil has surged nearly 30% in the second half. This jump reflects the impact of Saudi Arabia's and Russia's voluntary production cuts in tandem with continued demand recovery. Saudi Arabia has been incredibly disciplined in their ability to cut supply, but they are fortunately not expected to extend production cuts into 2024 if prices remain high. Supply from Iran continues to grow, while Russian supply remains a risk and could be cut further. As for the US, shale output is slowing as the rig count falls and capex plans are held in check by pressure to return capital to shareholders, but higher prices will entice US producers to ramp up production. Global growth could be 0.5% lower over the next two quarters if prices remain at these elevated levels, and there is scope for oil prices to continue rising – which is a risk for global inflation.

Chart 4: Oil prices are being supported by stable demand and increasing supply cuts



Source: Bloomberg

Metal prices face risks from the United Auto Workers (UAW) strike in the US, where the UAW and Big Three Detroit auto original equipment manufacturers are poles apart on new contract terms. The last significant US autoworker strike was in late 2019, when steel prices fell by over 15%. Aluminium and palladium demand look most vulnerable this time around.

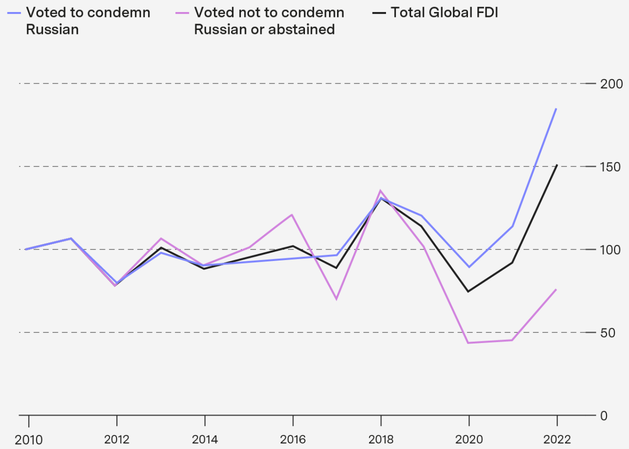
South Africa – Running out of time

By Viwe Gqiba
Investment Analyst

- Countries opposing Russia's invasion of the Ukraine have seen increased foreign direct investment, but South Africa is experiencing economic decline, governmental strain and delayed reforms, highlighting extensive vulnerabilities.
- South Africa faces impending inflation and intensified economic challenges amidst rising oil prices and a weakened rand.

The value of FDI to countries that voted to condemn Russia is surging, while FDIs to those countries that abstained have fallen. South Africa is on the losing side in this regard, which is bad news for our growth and job creation forecasts. China has been hard hit, with inbound FDI falling to its lowest level on record. Mexico is reaping the benefits of US-China tensions and has become the US's biggest trading partner. Companies like Tesla, GM and Kia are piling into Mexico with billions of dollars in investments and new factories.

Chart 5: FDI investment has favoured countries that condemned Russia's invasion of the Ukraine



Source: Bloomberg

South Africa's budget deficit rose to a record monthly deficit of R143.8 billion in July. Government has announced it will have to introduce stringent cost-cutting measures, including a freeze on new public service jobs, stopping procurement contracts for all infrastructure projects and keeping public servant salary increases in check. These measures could have a negative impact on the economy. If they lead to a cut in the provision of social grants, they could also cause social unrest.

> "South Africa's budget deficit rose to a record monthly deficit of R143.8 billion in July."

Government has also promised to introduce reforms to boost jobs, growth and tax revenue, but these reforms have been delayed. President Ramaphosa promised his Social Compact would be delivered in 100 days, and it has now been over 600 days with no agreement between government, labour and business. In the meantime, the country's state-owned enterprises are struggling. Transnet has requested relief from preferential procurement rules in order to source material directly from original equipment manufacturers and avoid the additional costs and delays of middlemen. Pravin Gordhan has proposed the biggest shake-up of state-owned companies since the 1990s to fast-track reforms. The plan will see the Department of Public Enterprises replaced by a state-owned holding company, but the bill has been criticised for its lack of detail about how the structure will work.

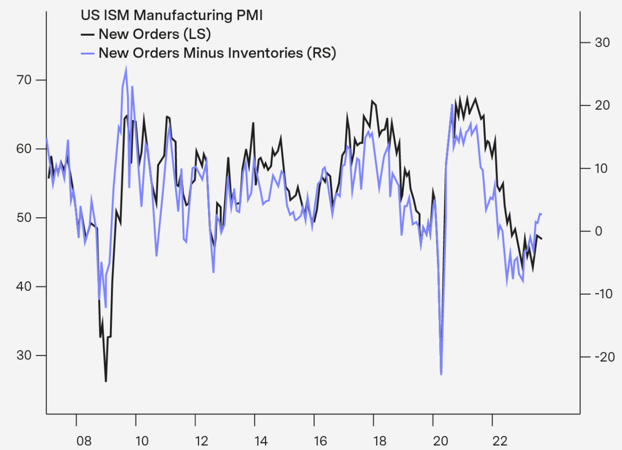
Consumer inflation increased marginally in August, to 4.8% year on year from 4.7% in July, and the SA Reserve Bank kept interest rates stable at its September meeting. Given the rise in oil prices and the weak rand, we could see a second wave of inflation in September.

Outlook – A recovery is possible, but we retain our cautious outlook

By Iain Anderson
Co-Head: Investments

The global economy is at a crossroads. On the one hand, there are tentative signs of a rebound in global manufacturing. The new orders and new orders-to-inventory components of the global manufacturing PMI are turning up. This suggests that businesses are starting to invest again and that demand is picking up. On the other hand, the global economy faces significant headwinds. The US is likely to experience a slowdown in the coming months as higher interest rates take effect and consumers run out of excess savings. In addition, China is experiencing deflationary conditions, and the war in Ukraine continues to cast a shadow over the global economy, disrupting supply chains and pushing up energy prices. Against this backdrop, it is difficult to be optimistic about the prospects for risk assets. While European and emerging market stocks could have a reprieve in the coming months, this is likely to be only temporary if manufacturing recovers. The global industrial cycle is not yet in a position to sustain a strong recovery – as such, it is important to remain cautiously positioned: underweight equity and emerging markets and overweight the dollar and the US. A more positive outlook would require interest rate cuts globally, de-escalation of the war in Ukraine or strong stimulus from China. However, conditions could also get worse if supply disruptions cause the oil price to spike.

Chart 6: Global manufacturing may be starting to stabilise



*Institute for Supply Management
Source: BCA

Key indicators

		1 mo.	3 mos.	6 mos.	1 yr.	2 yrs.	3 yrs.	5 yrs.	10 yrs.
J203T	**FTSE/JSE All Share Index**	-2.5%	-3.5%	-2.8%	17.7%	10.4%	14.5%	9.3%	8.6%
J200T	**FTSE/JSE Top 40 Index**	-3.1%	-4.6%	-3.7%	19.8%	11.3%	14.2%	9.9%	8.8%
J210T	**FTSE/JSE Resources 10 Index**	1.0%	-5.4%	-11.4%	-0.5%	4.8%	8.7%	11.4%	5.9%
J211T	**FTSE/JSE Industrials 25 index**	-4.4%	-6.8%	-3.3%	29.5%	11.8%	12.5%	9.5%	8.9%
J212T	**FTSE/JSE Financials 15 Index**	-3.8%	2.0%	8.0%	23.6%	10.6%	22.3%	4.2%	7.8%
J403T	**FTSE/JSE SWIX Index**	-3.1%	-4.0%	-2.8%	12.2%	5.8%	11.2%	6.2%	7.1%
J433T	**FTSE/JSE Capped SWIX Index**	-3.0%	-3.8%	-2.7%	11.9%	6.4%	13.8%	6.4%	6.9%
J303T	**FTSE/JSE CAPI Index**	-2.5%	-3.4%	-2.9%	16.4%	10.1%	15.6%	9.3%	8.6%
J253T	**FTSE/JSE SA Listed Property Index**	-4.1%	-1.0%	-0.3%	12.9%	1.5%	16.8%	-3.5%	1.5%
ALBI	**JSE All Bond Composite Index**	-2.3%	-0.3%	-1.9%	7.2%	4.3%	7.0%	7.2%	7.2%
STeFI	**STeFI Index**	0.7%	2.0%	4.0%	7.4%	6.0%	5.2%	5.8%	6.3%
	MSCI World Index in SA Rands	-4.8%	-3.7%	9.5%	27.8%	10.8%	12.6%	13.6%	15.3%
	Rand/US Dollar Exchange Rate	-0.5%	-0.3%	6.2%	4.8%	11.9%	4.1%	5.9%	6.5%
	Rand/Euro Exchange Rate	-2.9%	-3.2%	3.5%	13.3%	7.0%	0.7%	4.0%	3.9%
	Rand/Pound Exchange Rate	-4.2%	-4.3%	4.8%	14.6%	6.5%	2.2%	4.5%	3.5%
	Headline CPI	0.3%	1.4%	3.0%	4.8%	6.2%	5.8%	4.9%	5.1%
	PPI	1.0%	0.9%	2.5%	4.3%	10.3%	9.2%	6.9%	6.3%