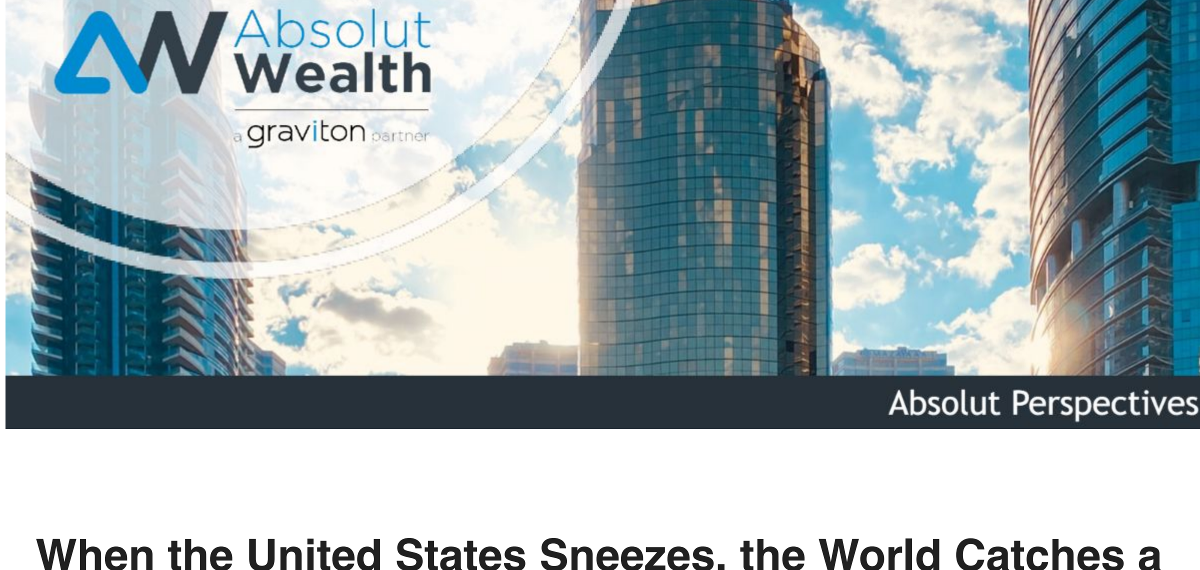


When the United States Sneezes, the World Catches a Cold

Richard Harris | June 2022

The US economy plays a significant role in the global environment as it contributes approximately 25% to global GDP ($21Tn in 2020), seconded by China at R12.2Tn with Japan contributing the third highest at $4.9Tn. (South Africa comes in at 32nd with a GDP of $350Bn).

Another staggering fact is that the United States makes up over 60% of the global stock market capitalisation with no other country coming close (Japan makes up 5.5% and China only contibutes 3.62%).

The reason for America's dominance comes as a result of its pro-growth environment since the early 2000s, as capitalism has been pushed and accommodation from the world's largest Central Bank has been granted in almost every form. The US has been the centre of most investment returns over the same period with massive innovation in the technology sector and "mega tech" firms like Microsoft, Amazon, Google, Facebook, and Apple taking the stand as global leaders in their respective industries.

It, therefore, should not come as much of a surprise that when the US economy is booming, there is a similar sense of excitement across many global markets as they participate in the upside and their industries benefit from the demand created by this goliath of a country.

The same is true, however, when the US economy slams on the brakes, as we have seen so far in 2022. In the last few months, we have seen an aggressive increase in US interest rates and tapering as the Federal Reserve tries to stem inflation using the best arrow in their quiver - to slow down demand. The result of this is a reduction in the monetary base, slowing consumer spending, a reduction in PMI (Purchasing Managers' Index - index of the prevailing direction of economic trends in the manufacturing and service sectors) numbers, and a large question mark hanging over the US housing market in which the average US house has gone up more than 30% in the last 2 years and mortgage rates have more than doubled recently.

Although the US has built its economic strength up in the recent past with unemployment sitting at just 3.5% and more than 10 million excess jobs remaining on the market, one must keep a close eye on consumer sentiment and the adverse effects it has on the economy when things start to turn. When people feel the effects of less "perceived wealth" and higher interest payments, the opposite to the exurberance witnessed in the market throughout 2021 will become evident.

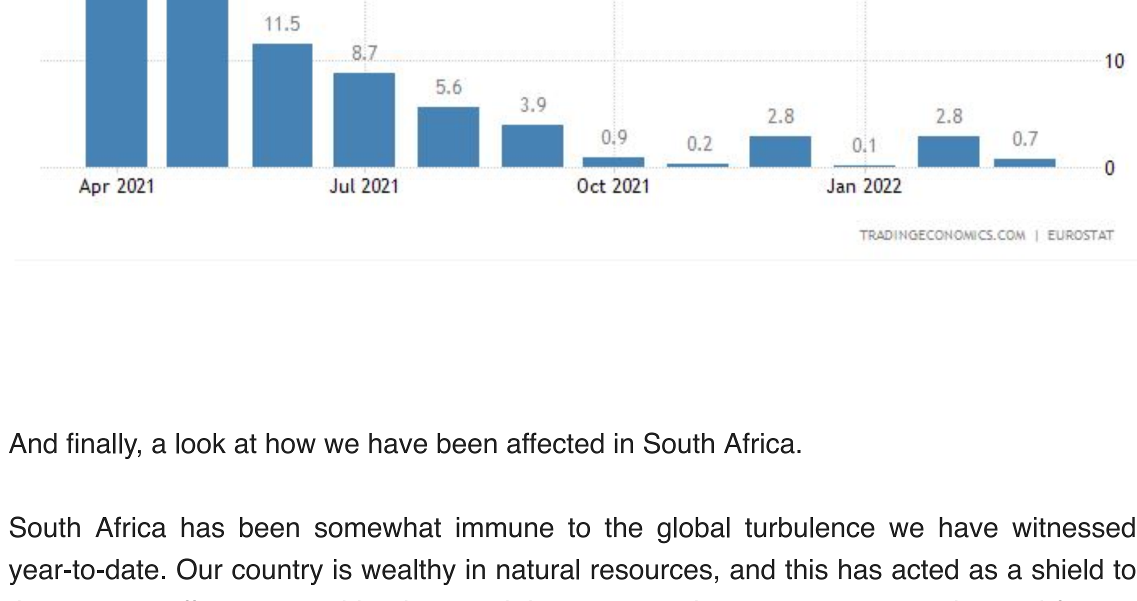
On the other side of the Atlantic Ocean, we have Europe, which has not been doing itself many favours either and seems to be on a path to self-destruction with many EU participant countries stuggling financially and a major unforeseen energy crisis being borne from the Russia-Ukraine war. Europe has imposed sanctions on Russia as a result, making sense from a humanitarian point of view but could be somewhat akin to shooting themselves in the foot based on their reliance on Russian resources (which could lead to a greater humanitarian issue down the line due to energy issues and food shortages in Europe).

The European economy was somewhat vulnerable prior to this shock, with interest rates being held at zero since 2016 in an attempt to spur economic activity. Now, as in the United States, inflation is running riot and despite the current economic weakness, the European Central Bank (ECB) is being forced into a corner where their only choice is to raise interest rates to combat this aggressive rise in prices. Real GDP growth forecasts in the EU have, therefore, been slashed to 2.7% in 2022 and 2.3% in 2023 (down from 4% and 2.8% respectively).

Euro-area Consumer Price Inflation (CPI) is now also topping 8% and the Producer Price Index (PPI), which measures the rise in producer costs, rose 30.2% year-on-year (yes, 30.2%); a figure that has impacted factory output with numbers slowing almost to a complete halt in 2022 (as seen in the graph below). This means that the European consumer should be weary of further rising costs in the near term as producers are likely to pass these costs on over the next year and there is no clear end in sight to the Russia-Ukraine saga.

What needs to be highlighted is that the US economy and population are in a significantly stronger position than the Eurozone and monetary contraction through Central Banks is likely to have greater adverse effects on Europe as a result of this relative weakness.

Euro-area Industrial Production (April '21 - March '22)



And finally, a look at how we have been affected in South Africa.

South Africa has been somewhat immune to the global turbulence we have witnessed year-to-date. Our country is wealthy in natural resources, and this has acted as a shield to the external effects caused by the world this year. We have seen a rise in demand for our exports, together with a decrease in our demand for imports. This has buoyed our current account and as a result, the Rand. Our stock market and economy have also benefited from this windfall and consequently, have been less affected than their global counterparts.

To the surprise of most, inflation has also been somewhat contained in South Africa; however, we are an oil and, largely, a manufactured goods importer, and said inflation is starting to show its head in recent prints with CPI pushing to 6.5% (vs 6.1% expected) in the latest reading from May. Should this inflation continue to rise, the South African Reserve Bank (SARB) will need to continue to raise interest rates locally, which will have negative effects on our population and economy, especially given the current weakness of our lower/middle class population and our high unemployment rate.

If global Central Banks succeed in slowing demand to stem inflation, and economic growth as a result in the next 6-18 months, we are likely to see a reduction in commodity prices, to a degree, and the above tailwinds that have helped South Africa's economy, current account, and Rand, will be reversed.

Although the above paints a rather sombre picture, it is not all doom and gloom and, as we have seen in the past, the world will emerge from this current distress. Central Banks are currently in a tough position and due to recent policy error, are having to do whatever it takes to slow inflation, which will likely have a greater effect on the economy than a recession.

Central Banks need to taper and raise interest rates to such a point that they will be able to "pivot" when their economies once again need the support. As it currently stands, they are damned if they do, and damned if they don't. We believe that rate hikes and monetary contraction will continue to be a theme throughout 2022 and only when inflation is contained, or global economies and markets fail to deal with the economic stress created, will Central Banks go back to providing markets with the liquidity that they have become so used to. It is then that we are likely to return to a more consistent and measurable uptrend in general.

In the meantime, while markets are volatile and establishing themselves in a new regime, opportunities for long-term capital growth are presenting themselves in abundance. Those that are patient and prepared will ultimately benefit significantly when the world finds a solution to current headwinds and economies return to a state of "normalcy".

Market Review

June saw another volatile month with daily moves of more than 1% up or down becoming the norm.

The Chinese Shanghai and Hong Kong's Hang Seng managed to buck the global trend, finishing up 12% and 6% respectively, with investors seeking value in the two already beaten-down indexes. The western world, however, fared less well, led lower by the German Dax (-12.5%), and the S&P500 and NASDAQ100 both giving back around 8% after a fairly strong finish to the month of May; these moves lower catalysed by increasing inflation and the Federal Reserve's first 75Bps (0.75%) rate hike since 1994.

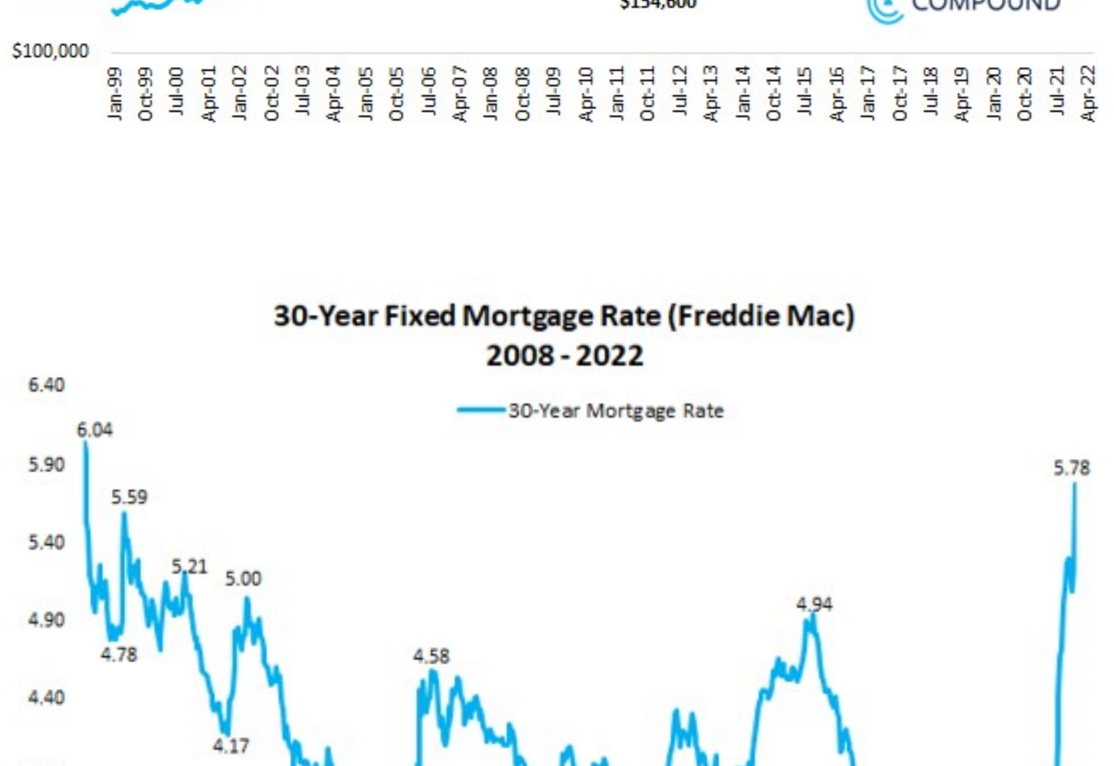
The local Top40 and Allshare Index sold off around 6% despite news of Naspers and Prosus's intention to dispose Tencent shares in an attempt to unlock their NAV discount. Commodities, which have been the driving force of returns locally in 2022, suffered significant losses in June with the J210 Resource Index closing down almost 16%.

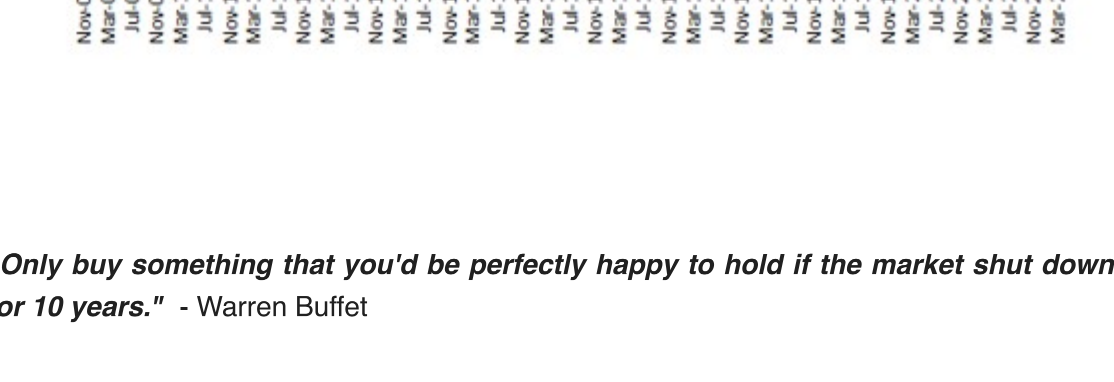
The Rand started the month off well at around R15.30/$ but was unable to ward off the effects of decreasing commodity demand, it's potential effect on our Current Account surplus, and the news of extensive loadshedding towards the end of the month, as Eskom employees continued to strike and the economy was once again brought to its knees by stage 6 power outages.

Our market outlook, both locally and offshore, still remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Charts of the month:

The charts below illustrate two important data points relating to the US housing market. The first shows the drastic increase in median sales prices of US homes since 2020 (+~30%). The second shows the rapid increase in mortgage rates over the last year. The two go hand-in-hand and a significant rise in mortgage repayments combined with such elevated property values doesn't bode well for the US consumer, especially given that the US stock and housing market are the predominant contributors to US wealth and "perceived" wealth.





"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." - Warren Buffet