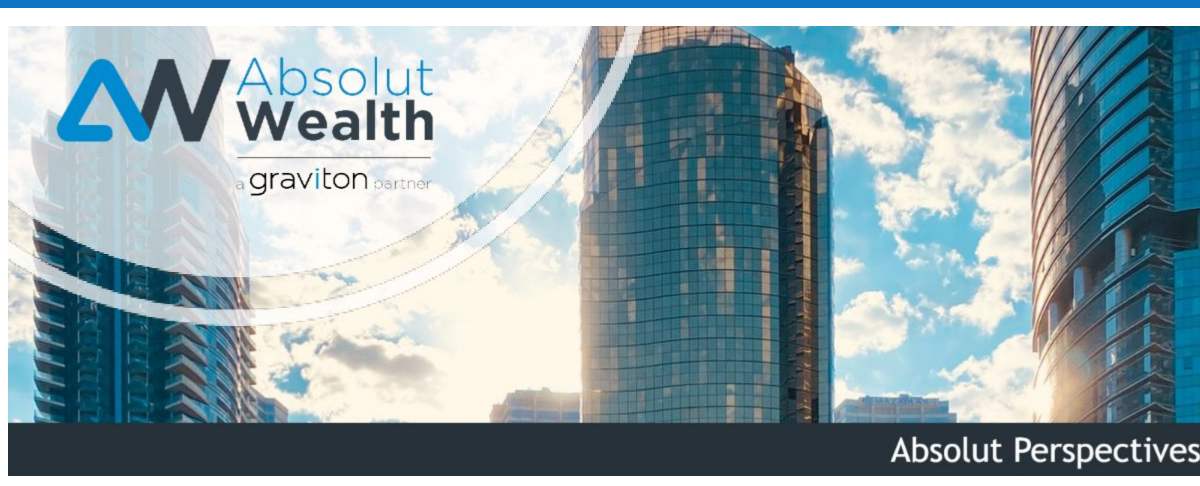
March 2022



Central Banks - Between a Rock and a Hard Place

Richard Harris | Mar 2022

Global Equity and Bond markets have ground to a halt in 2022 with volatility showing prevalence as Central Banks attempt to contain increasing inflation figures not seen in decades.

It was inevitable that the recent wall of money being thrown a global economies, combined with COVID-related manufacturing interruptions, was going to have an inflationary effect on goods and services; this was recently exaggerated by the Russia-Ukraine war and its effect on the global supply of commodities. Not many predicted the degree to which inflation would increase and there is no clear end in sight.

Before proceeding, I would like to differentiate between Nominal Interest Rates and Real Interest Rates, as they form part of the material below:

- Nominal Interest Rate: The interest rate before taking inflation into account (*interest rate set by Central Banks*).

- Real Interest Rate: The nominal interest rate adjusted for inflation (*i.e., nominal interest rate less inflation*).

Central Banks are generally mandated to ensure the economic prosperity of their nations, oversee the financial system, and control the strength of their currencies. Within this broad mandate, most are required to ensure sustainable employment and maintain a certain targeted level of inflation that will allow for positive real interest rates. Positive real interest rates ensure that the local currency holds its relative value if invested in Government Bonds (which are considered safe).

If real rates are negative as a result of high inflation or low nominal yields (or both), people need to chase higher risk investments to maintain their purchasing power, which in turn, can lead to asset bubbles and unrealistic valuations.

2021 was a bumper year for Equity markets seeing them catapulted higher, and speculative bubbles formed all over the place; to name a few:

- Non-Profitable Technology companies traded at multiples that made very little sense.
- Markets continued higher with little regard to valuations.
- Social Networking communities, like Reddit, blew up established Hedge Funds by cornering their positions and acting as one against them.
- Certain Cryptocurrencies, the one based on a dog breed (Shiba Innu), moving 14,000,000% (that's not a typo) over a 5-year period.

Needless to say, this offered good material for discussion on the golf course, but in essence, what was being witnessed was the adverse effects of too much money, without a specific agenda, being pushed into global economies in an effort to negate the effects of the Pandemic.

We now sit in 2022 and despite the general 2021 tone from Central Banks being that inflation will be transitory, we find ourselves in a situation where prices are skyrocketing, and the real value of our money is quickly being eroded.

The effects of inflation are felt at different degrees over the various levels of wealth. The wealthy are generally able to absorb these effects to a greater extent yet, the middle/lower LSM (where basic goods make up the majority of monthly expenses) are being greatly affected.

The disparity between the rich and the poor has increased significantly over the past decade, and for that reason, high inflation is a serious concern and something that needs to be addressed with urgency.

Containing Inflation

Central Banks should have realised that at some point stimulus measures would need to slow and that interest rates (nominal) would need to rise as the economy naturally found its feet. However, they are now in a situation where they are being forced to act by withdrawing stimulus (tapering) and raising interest rates in a desperate effort to stem global demand and slow inflation figures that are more manageable (their previous inflation target was +/-2%).

Should Central Banks not step in and put a stop to this inflation, the repercussions could be devastating, especially with commodity prices remaining strong due to supply shortages.

To sum up the above, Central Bankers and Policy Makers usually initiate contractionary monetary policies (increase rates and withdraw stimulus) when economic growth is forecast to remain upward and/or if inflation is above the desired level (+/-2% in most developed economies).

The process of contractionary monetary policy is usually done on an ad hoc basis that allows Policy Makers to be more or less aggressive as the economy responds, allowing for a smoother transition.

Unfortunately, this is not the case in the current global environment. Inflation has risen to such a level (7.9% in the US) that drastic action needs to be taken in the form of rate hikes and stimulus withdrawal (the US Bond market has already priced in 7 rate hikes of 0.25% in 2022).

It has yet to be seen what effects this will have on global economies and stock markets that have become so accustomed to receiving aid over the past 15 years. Another concern is that global growth is said to have peaked in Q3/Q4 2021 and raising interest rates into slowing economies like this has not been seen before.

This is likely to create more headwinds than tailwinds for Global stock markets in the short term as consumer demand slows, company earnings stall and global economies try to find a new equilibrium. Opportunities will present themselves during this transition, rewarding those who are patient and creating excellent buying opportunities for longer term investors.

Market Review

The largest gainers of the month were Automotives, Gold, and Energy, with Consumer Staples, Airlines, and Asian Tech taking the wooden spoon. Commodities continued to fly with Crude Oil up 25%, Iron Ore up 14%, and Aluminum up 9%.

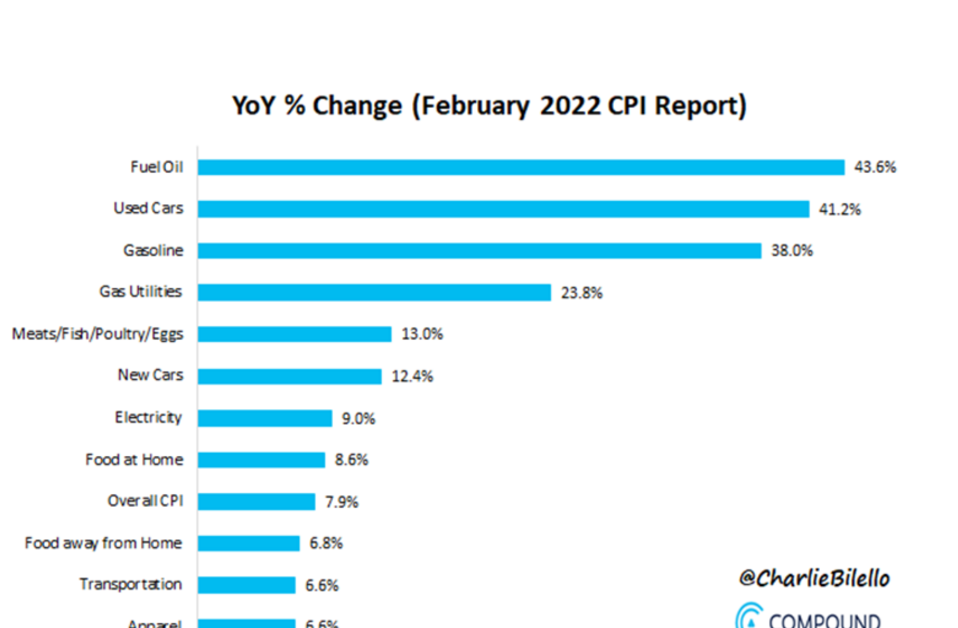
Bonds sold off globally with Central Banks reinforcing their need to hike rates sooner rather than later. The US 10-year Treasury Bond is trading at 2.4% as I am writing this newsletter.

The South African Rand (+6%) and other Emerging Market (EM) currencies remained resilient as global funds shifted from other volatile EM regions to those less impacted by the events in the East. The South African Rand also benefitted from further local rate hikes and continued strength of commodity prices as a result of shortages coming from the Russia-Ukraine war.

Despite recent moves, our market outlook, both locally and offshore, 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, which we look to deploy into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Chart of the Month:

The Chart below highlights the increases in prices of various goods and services in the United States from February 2021 to February 2022. Some of the largest increases are attributable to consumer staples (i.e., food and energy products). It is essential that inflation on such items be contained in order to maintain the purchasing power of a country's currency and protect the spending power of the consumer.



"In many ways, the stock market is like the weather in that if you don't like the current conditions, all you have to do is wait a while." - Low Simpson