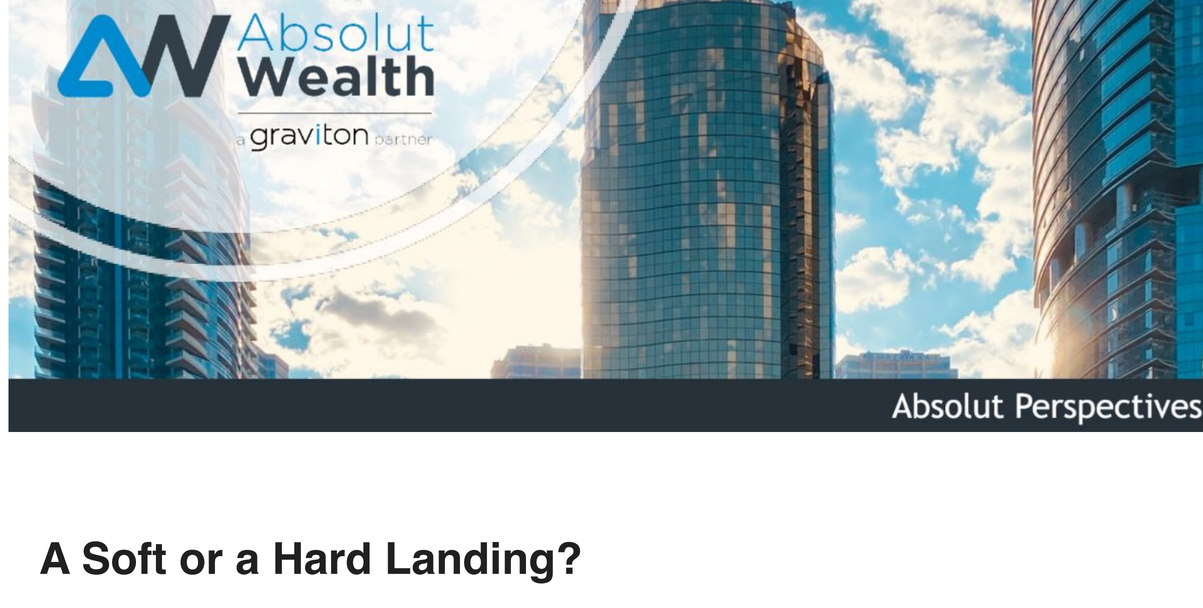


A Soft or a Hard Landing?

Richard Harris I February 2023

There is much debate among global investors and economists about how the recent tightening of financial conditions will affect global economies, and whether economies are robust enough to heed off these recent headwinds and thus achieve a "Soft Landing".

Before I proceed, let me briefly outline what is meant by the above terminology:

A Soft Landing -

A soft landing points to a stage of the business cycle where an economy is shifting from a high growth to a slow growth environment but manages to do so by avoiding a recession and is therefore able to rebound faster when Central Banks change their tone from restrictive to accommodative.

A Hard Landing -

A hard landing refers to the opposite of a "soft landing" and is the metaphor used to describe economies that run into a sudden, sharp slowdown on growth that is likely followed by a recession as Macroeconomic data points deteriorate because of a
Looking at the above, one would most likely be inclined to say that given recent macroeconomic data points, a soft landing may be plausible and that we can expect a "pivot" from Central Banks in the near future.

This, however, may not be as it seems. The main reason being that Central Banks are doing everything in their power to curb inflation and mitigate its devastating effects on consumers in general. To achieve this, and reiterated by the Federal Reserve, there needs to be a targeted destruction of demand to slow consumer spending and bring inflation back under control.

So long as global growth remains flat or higher, with inflation above its mandate, Central Banks will maintain their stance on monetary tightening until the time that this demand is reduced, and inflation comes down as a result. Then the discussion on whether the landing will be "soft" or "hard", as defined above, will need to be had.

After a tremendous start to the year, and many market commentators praising the notion of a potential soft landing, we have seen a change in dynamics for the month of February. Many money managers are starting to see through this "soft landing" narrative and are focusing once more on the fact that these strong datapoints generally improve consumer sentiment and demand as a result, adding to persistent global inflation.

As a result, investors are now positioning their portfolios for further rate hikes, with interest rates then plateauing but staying higher for longer to bring inflation back under control. On the back of this, Bond yields have once again climbed and the US Dollar has strengthened against global counterparts, similar to the dynamics that caused the market sell-off in 2022.

As mentioned in previous newsletters, the effects of monetary tightening are lagged and generally not witnessed in the economy until 12-18 months after the initial policy change. This is because it takes time for the consumer to grasp the effects of higher interest rates on their disposable income.

I will try to illustrate the following example from the point of view of an American consumer:

Early 2021

- Interest rates are currently at 0.25% and combined with a recent sizable COVID bailout package, the economy seems strong. The US individual currently has sufficient savings and is being paid a good salary that allows for an upgrade to their house and car.
- Because interest rates are low, the individual decides to buy a house and car that may be somewhat above their means, as they can afford the repayments with their current income and perceived wealth.
- All is well and their family/friends are doing the same.

Late 2021

- Due to the scenario mentioned above, prices start to increase as demand outweighs supply (inflation is rising).
- Central Banks become aware of rising inflation and start discussing how to curb inflation by raising interest rates and removing money from the economy.
- Inflation, as measured by CPI, moves from 2% to 7% at the end of the year and Real Estate, Vehicles, and other Consumables prices are now significantly higher than the start of the year.

2022

- Russia invades Ukraine and adds further supply side inflation to the equation. Inflation is now running out of control, pushed even higher by rocketing food and energy prices.
  - Oil prices increase by more than 30% in 2 weeks after the Russian invasion.
- As a response, global Central Banks, led by the US, act quickly to slow this inflation by raising interest rates aggressively.
  - Rates are raised from 0.25% to 4.5% by the end of 2022.
  - Interest rates are now roughly 18 times higher than a year ago.
- This rise in interest rates has now increased repayments on mortgages by roughly 35% during 2022.
  - As a result, house prices are starting to fall and new construction projects have come to a halt.

Early 2023

- Although declining, inflation numbers continue to persist, and global macroeconomic data shows that the economy is still flourishing with demand remaining much the same and inflation remaining sticky as a result.
  - The accuracy of the above datapoints also comes into question as there are seasonality effects which may influence the metrics higher. From company announcements, it is clear that, in general, earnings are deteriorating and layoffs are starting to occur.
- It is now February and Central Banks continue to be vocal about this persistent inflation, reiterating that they will continue to fight it by raising interest rates and keeping them higher for longer.

How this all comes together for the consumer

- The individual is now sitting with household and vehicle debt where instalments have increased by more than 30% year-on-year.
- Their income is unable to afford these magnified payments, so they start depleting savings in order to maintain the lifestyle that they are now accustomed to.
- Once their savings have been depleted, they begin to take on credit to survive.
- As a result of others experiencing similar constraints on disposable income, consumer demand starts to deteriorate.
- This leads to declining prices as discretionary spending slows.
- Companies are now laying off part of their workforce and cutting costs to maintain margins and earnings.
- The individual's monthly repayments eventually become unaffordable and they decide to sell their car and house in order to survive. However, car and house prices are now lower.
- They are now left with assets that are less than what they originally paid for them and their monthly payments on these debts are significantly higher than what they had initially committed to.
- Sound familiar?

This may seem like an extreme example, but it highlights the point I am trying to get across and is not too farfetched from the environment that we have been observing post-COVID.

There is an argument to the above where some point out that most of the debt mentioned above is fixed rate. This, however, only applies for a certain period and when the refinancing of that fixed rate debt occurs, the effects discussed will come to roost, albeit more noticeably.

Where does this leave us?

It is likely that the next few months will remain tumultuous as the forces mentioned above play out.

Despite the potential turbulence ahead, there are many positives for investors over the next decade, and it is likely that active asset management will ultimately prevail. Many asset classes, however, are showing favourable entry points for secular market trends over the next decade:

THE ENERGY SECTOR

Due predominantly to supply constraints but also to increasing global demand, we can expect energy to be a major theme over the next decade.
These forces and increased demand for renewables should create tailwinds for both conventional and renewable energy.

HARD COMMODITIES

Advancements in technology and the requirement for hard commodities as a result, coupled with the fact that commodities are finite, should create continued demand for commodities going forward.

VALUE / QUALITY COMPANIES

Due to the strong nature of the balance sheets of these companies and their defensive earnings growth, regardless of the stage of the business cycle, Value / Quality companies should outperform Growth companies during this transition.

FIXED INCOME

Developed market yields have risen sharply since the beginning of last year and are now offering a respectable yield for investors. US Treasuries are now yielding as much as 5% (up from 0.25% at the beginning of last year).

It is important to note that some of the best long term investments are made when markets are volatile.

Market Update

February saw markets retrace as investors started repositioning their portfolios for extended monetary tightening from Central Banks.

We saw indexes decline across the board with the UK FTSE and German Dax "bucking the trend" and closing up marginally in February.

Brazil, Hong Kong, and US indexes led the way lower after a strong start to the year. Brazil's BOVESPA was down 6% with the Hang Seng, Dow Jones, and S&P500 following lower, down 6.5%, 4.2%, and 4%, respectively.

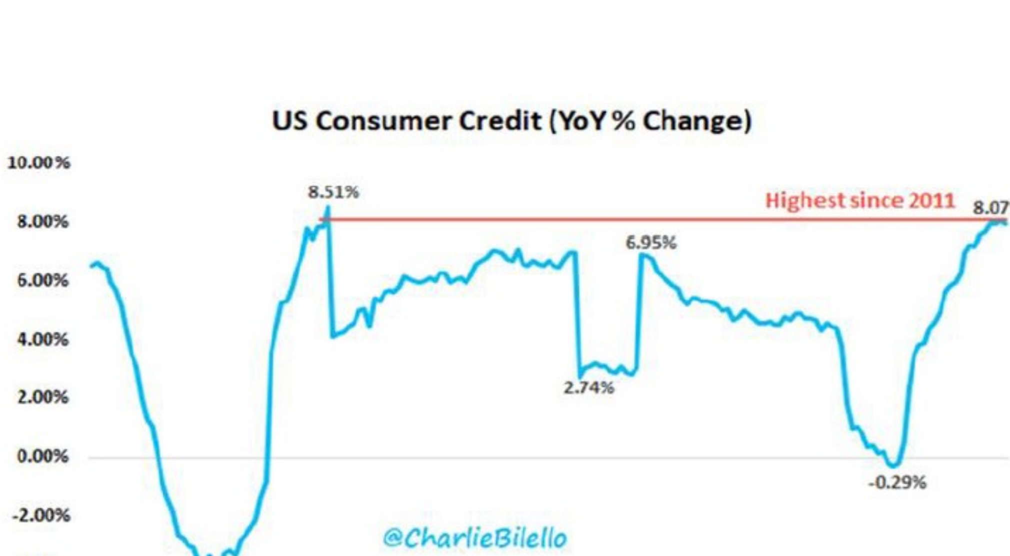
South Africa's Allshare Index was only down marginally, mainly due to the fact that the Rand depreciated by more than 7% versus the Dollar, as local politics and instability continue to disrupt our economy. As I write this note, the Rand is off it's monthly highs of R18.50/$ (currently trading at R18.21/$). Despite a massive move in the wrong direction in February, a lot of bad news should be reflected in the current price, with Stage 7 loadshedding being announced, a less than desirable budget speech reflecting economic woes and a damning report from Andre De Ruyter about the corruption at Eskom.

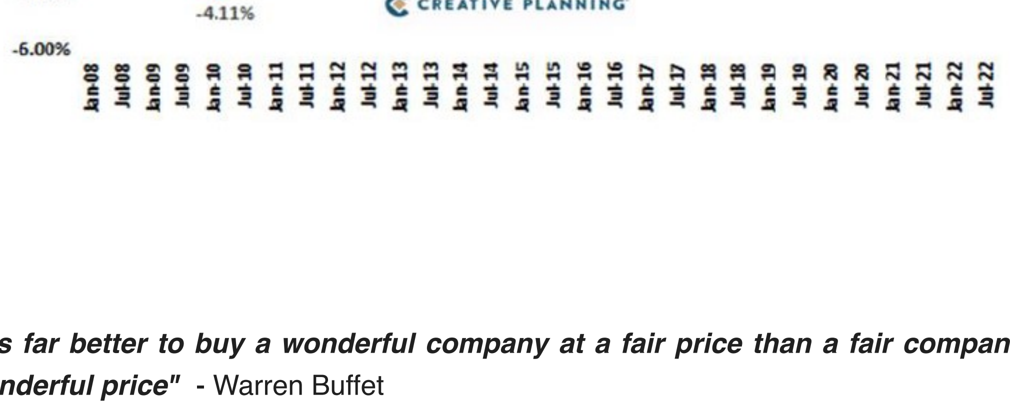
Commodities were mixed for the month, as those used predominantly in manufacturing, such as Steel and Copper, remained strong. Precious Metals on the other hand, traded lower due to the effects of higher interest rates globally and a stronger US Dollar.

Our market outlook, both locally and offshore, continues to remain cautious, as we monitor ongoing global developments and commentary from Central Banks. We remain defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. We will look to deploy 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 highlight the illustration mentioned in the newsletter above. What you can see is that US personal savings has been depleted over the past year whilst consumer credit continues to rise. All this, whilst US interest rates have risen substantially.





"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price" - Warren Buffet