*THE QUART 40IFO*

OFFICIAL QUARTERLY NEWSLETTER OF **THE OSRIN GROUP**
INCORPORATING OSRIN WEALTH & OSRIN ADVISORY

# Quarter Two 2021 in Review

## Introduction

**Welcome to the Quarter Two 2021 edition of The Quart. While I sit to compose my introduction to this edition, I have the TV on the eNCA news channel. It is difficult to comment on the past quarter when confronted by chaotic scenes of anarchy, criminality, and the wanton destruction of property. The total disregard for the rule of law is astonishing. One wonders where we go to from here. To be fair to the Judge, these developments are occurring post 30 June, so he will cover them in the Q3 edition. Please G-d by then some semblance of law and order will have returned.**

It is the virus that just won't quit. We have seen a return to level 4 lockdown, the closure of schools, a 21h00 curfew and the suspension of alcohol sales. These measures are enough to challenge all of us daily. Add to that the crushing England exit from the Euros on penalties, and the freezing cold temperatures and all that is left is for us to hope for is some excitement from the upcoming Tokyo Olympics. With no crowds to cheer on the athletes and the 7-hour time difference, even this is going to present its challenges.

**[A QUART]** Def; A unit of liquid measure of capacity, equal to one fourth of a gallon, or 57.749 cubic inches (0.946 liter) in the U.S. and 69.355 cubic inches (1.136 liters) in Great Britain. Or a unit of dry measure of capacity, equal to one eighth of a peck, or 67.201 cubic inches (1.101 liters).

**The office at 2 Long Street continues to function with a rotation of staff members present on a daily basis. We are all contactable during office hours on our emails and cell numbers. We continue to carry out investment research functions on Zoom and/or Teams and administrative functions with our trusted service providers.**

By now we are all well versed in the WFH rituals. The (up until 24 hours ago at least) firm rand provided many clients the opportunity to avail themselves of Discretionary and Foreign Investment Allowances and our ability to efficiently assist clients with the process of investing offshore was of great benefit. We have, in general seen an uptick in requests for offshore structuring and offshore investing over the past few months.

This edition of The Quart looks at a critical focus of macroeconomic policy, namely inflation. Inflation has for the past number of years not received much attention. Low oil prices and the explosion of disinflationary technological advancements as well as cheap goods out of China have led people to believe that inflation is a worry of the past. The cutting of global interest rates to zero and below since the Global Financial Crisis in 2008 has seen people getting accustomed to "free money" and inevitably leverage has crept back into the financial system. The announcement of record stimulus packages by Presidents Trump (as he was leaving office) and Biden (as soon as he got his feet under the desk and his sunglasses on) have served to increase household wealth. Pent-up demand due to the Covid pandemic and an inability to produce and deliver goods to meet that demand has led to intensifying inflationary pressures. In the US, employers have been unable to fill skilled positions so wages are climbing as well. The US Federal Reserve is now beginning to discuss tightening financial conditions initially through tapering its massive bond-buying programme.

It is inevitable down the line that the talk moves to rate hikes. I will leave the Judge to elaborate on the detail and what a potential uptick in global inflation means for us as consumers and investors.

We hope you enjoy this edition of The Quart.

Jonathan & Bernard

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# The Quart is in Session

## Market Activity - A Steady Gradient

## Quarter Two 2021

The second quarter (Q2 2021) was characterised by pretty uniform stock market inclines with a few days of sharp retracements.

April was a solid month for US stocks. But markets were rocked on May 12 when April US inflation data came in very hot. The sell-off lasted two days. Investors rotated out of tech stocks, and the Nasdaq was down three out of four weeks in May.

From then on it was plain sailing until the Federal Reserve policy decision June 16 which was perceived as hawkish and led to three days of equity decreases. That week was the worst in the US since the week of October 31. But the following week saw gains and the best weekly performance since February. The S&P500 (S&P) ended the quarter with five straight daily gains and at a new record high. June was a better month for tech stocks and the Nasdaq ended just shy of a new closing record high as well. The Dow Jones Industrial Average (DJIA) came to within 2% of a new record by quarter's close.

In the end, the S&P put on 8.2% in Q2 2021 for a gain of 14.41% year-to-date (YTD) to end-June. The DJIA was up 12.73% and the Nasdaq Composite tacked on 12.54%.

Here in South Africa, the FTSE/JSE AllShare Index (Alsi) rose 12.09% for the year to end-June, while the FTSE/JSE Top40 Tradeable Index (Top40) added 10.93%.

South Africa fared well in relation to many other Emerging Market (EM) indices. In Brazil, the Bovespa ended June higher by 7.7% for the year, while the Shanghai Composite put on 2.52%. The MSCI EM Index, which is denominated in US dollars, climbed 6.70% to end-June YTD. The US dollar has declined 2.7% YTD against the ZAR, making local stock market performances more noteworthy.

The trade-weighted US Dollar Index (DXY) increased 2.7% in the year to end-June, while gold fell 8.8% in that time.

# Quarterly Themes

## 1. The US Federal Reserve - At The Front of The Peloton

The Federal Open Market Committee (FOMC) meeting on April 26-27 followed outsize growth in retail sales, multi-year highs for leading manufacturing indices and a near 1 million non-farm payroll number in March.

Members were of the view that while indicators of economic activity and employment had strengthened, helped by vaccinations and policy stimulus, the economic recovery was uneven and incomplete. And while inflation was rising, this was due to factors that would prove to be "transitory".

The Committee voted unanimously to keep the benchmark fed funds rate at the zero bound and maintain its policy of acquiring at least US$80 billion per month of Treasury securities and at least US$40 billion per month of agency mortgage-backed securities until "substantial further progress" had been made towards achieving the Committee goals of maximum employment and price stability. The tone was uniformly dovish. The FOMC was willing to look through the rise in inflation, even if this persisted a little while before prices moderated.

No timeline was attached to the word "transitory", but some Fed officials spoke later about a period of "several months" or "until early-2022". Whatever, the Committee had to be deliberately patient.

But long before rates are increased, the Fed's asset-purchase programme, which pumps prodigious amounts of new cash into the economy, has to be tapered, that is to say scaled back, and finally halted. The Fed's balance sheet has during the crisis been lifted inordinately from US$3.75 trillion to US$8 trillion.

Tapering is where the current policy debate is focused.

There were indications in the April FOMC meeting minutes that Committee members were c onsidering circumstances under which asset purchases could be scaled back. A "number" of meeting participants (not necessarily a majority) suggested that if the US economy continued to make rapid progress towards the FOMC's twin goals "it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases".

The sensitivity of financial markets to talk of possible discussions to taper purchases was evident. The DJIA ended down 165 points after troughing 586 points lower, while the Nasdaq was off 1.7% at its worst, but rebounded to close flat on the day.

In subsequent weeks a number of Fed officials came out to confirm that at some future point a discussion over whether to taper would have to be held. Analysts interpreted these moves as the Fed gently preparing markets for an eventual reduction in the current US$120 billion monthly securities' purchase programme.

And then came the June 15-16 FOMC meeting, which unlike the April meeting, was accompanied by an updated summary of economic projections of the 18 FOMC members.

Most telling was the Committee's altered economic projections.

In March, the view of the relevant core inflation measure was lifted to an above-target 2.2% in 2021 (previously 1.8%), easing to 2% in 2022 (1.9%), and 2.1% (2%) in 2023. The adjustment was not that large and was of a passing nature. However, in June the core PCE price index was seen running hot in 2021 at 3.4% (in truth a massive upward adjustment), decelerating to 2.1% in 2022 and 2.2% in 2023.

The view of FOMC members of the desired mid-point of the Fed funds rate going forward was instructive. In March, 11 members out of 18 took the view that no rate hikes were required through 2023. Now in June, only five members saw rates unchanged in 2023, with two foreseeing one rate hike of 25 basis points and 11 members (a majority) believing two rate hikes in 2023 would be required. Indeed, eight took the view that at least three rate hikes would be necessary. The rapidity of the rise in US inflation had clearly surprised.

## Cracks are beginning to widen on the Committee.

In his press conference Chairperson Powell characterised the recovery as incomplete with continuing risks to the outlook. He acknowledged rising inflation readings, but maintained that even if such readings remained elevated in coming months, they would moderate in time.

The higher inflation numbers were attributed in the main to a mismatch between supply and demand. The latter had rebounded strongly as the effects of the pandemic waned. But supply had been hampered by bottlenecks that were proving more lasting than first anticipated. In addition, difficulties around hiring and other constraints were limiting the responsiveness of supply. All this raised "the possibility that inflation could turn out to be higher and more persistent" than expected.

Longer-run measures of inflation expectations had reversed declines seen early in the pandemic, but were still well anchored and consistent with a longer-run inflation goal of 2%.

Powell made it clear that the Committee would signal any decision to taper asset purchases well ahead of time and was now focused on the question of when tapering talk would commence. While tapering discussions had not yet commenced, "talking about talking about" them had. Everything hinged on the rate of progress toward economic recovery.

After the policy decision, stocks were hit hard in the final three days of the trading week, the worst since October 2020. The US dollar Index (DXY), which moves in tandem with short-term rates, popped around 2% and the prices of commodities that move inversely to the US dollar fell sharply. However, the yield on the 10-year Treasury inched up only 5 basis points to 1.55%, and has hovered around the 1.50% pivot since, indicating the degree of control the Fed has over longer-term rates via its purchases of longer-dated Treasuries. All the action was at the short-dated front end of the yield curve.

On the following Monday, however, it was business as usual, with the DJIA enjoying its best day since March 5, higher by 1.8% to within 2.5% of its record level. The S&P500 was not far behind having lifted 1.4% to less than a percentage point off its record close.

The return to normalcy so soon after the Fed's hawkish turn was questioned by market watchers and the view that stock markets are mispricing both the timing and scale of future rate hikes is widely held.

## 2. Will US Inflation be "Transitory" - How Long is The Climb?

The elevated inflation projection contained in the Fed's June 16 policy output was a direct response to intensifying pressures coming through in the main readings of US inflation.

In April US Producer Price Inflation (PPI) jumped 0.6% on the month to an annual rate of 6.2%. In May, PPI climbed a further 0.8% to 6.6% the highest reading since the 12-month data series commenced.

US Consumer Price inflation (CPI) increased 0.8% on the month for April after a 0.6% upturn in March to reach an annual rate of 4.2%, the most elevated since September 2008. Core CPI (ex-energy and food), lifted 0.9% to a rate of 3.0%. In May CPI rose another 0.6% to 5% (the highest reading since August 2008), with core CPI getting to an annual rate of 3.8%.

The Fed's preferred inflation gauge, the core Personal Consumption Expenditure (PCE) Price Index was up 0.7% in April to a 3.1% rate for the year. And in May, after the June policy decision of the Fed, the core PCE Price Index got to an annual rate of 3.4%, the fastest pace since 1992. This is worryingly ahead of the Fed's inflation goal of 2%.

But the Fed is asking market participants not to worry because this state of affairs will prove to be "transitory"; the factors underpinning the rise in inflation are said to be temporary in nature.

We have heard the arguments:

- Base effects at work in the comparison between current prices and those at the outset of the pandemic when the economy and prices collapsed.

- Higher energy prices due to a strengthening economy, which are expected to level off.

- Fiscal stimulus which put money in people's pockets and raised spending that will run its course.

- The level of household savings built up during the pandemic which has occasioned a strong rebound in consumer demand, particularly for services. This too will dissipate.

- Supply bottlenecks, essentially supply chain constraints, which will be worked through in time.

- Excess demand for labour as the economy re-opened, driving up wages. Labour supply will eventually catch up.

The base effects' argument is a bit disingenuous. Even if we compare prices now with those of two years ago, we are still seeing increases in excess of 2.5%, materially above the Fed's inflation goal. It must be accepted that prices of goods and services are high in and of themselves.

## This sanguine depiction of passing inflationary pressures, in our view, ignores the possibility that some of the pricing changes we are seeing are due to structural factors that will be more long-lasting.

Take the labour market as an example. The pandemic led to a tremendous amount of innovation at the workplace in the form of digitisation and automation. This raised the level of requisite workplace skills and many former employees have simply not caught up, allowing those who are adequately skilled to bid up the price of their labour. Further, many left the workplace during the pandemic to take on responsibilities at home. A good deal of this cohort has not yet re-entered the workplace and might not do so. Some took the pandemic as an opportunity to change careers and require skilling before they can take on work again. Many more saw vital skills atrophy during the duration of the pandemic and similarly require upskilling. So, it is not as simple as labour supply quickly increasing to meet demand.

The principal inflation dampener for the past decade and more has been China's exporting of goods deflation. However, the relationship between China and the US has altered fundamentally. It has become more adversarial. Free trade has been replaced with reciprocal tariffs driving up the prices of consumer goods.

It is acknowledged that supply chain disruptions are clearly having an impact on the availability of goods and affecting their pricing. Much of this has to do with demand overwhelming supply as the pandemic receded. China's PPI is proceeding at a staggering 9% pace annually and the cost of freight has surged as container space diminishes and harbours remain clogged. However, this has occurred just as many companies and countries are reconfiguring their supply chains to reduce their dependence on China. This is a more durable phenomenon and has also contributed to supply chain dislocation.

And not all price rises are wholly supply-chain related. Many raw materials such as iron ore and copper as well as oil are rising because of expectations of a bumper economic cycle to come. Were supply constraints to disappear the prices of these materials would remain high.

When prices go up, consumers tend to expedite and increase purchases to avoid paying more down the line. In this way inflation becomes self-fulfilling. This process has been evident in the semiconductor space. Prices are rising because purchasers, anticipating further price hikes, are buying in bulk in the here and now. This self-fulfilling behaviour does not just disappear in a matter of months. Rather it has a tendency to become entrenched sustaining price rises, even after supply issues have been resolved.

## 3. Infrastructure Deal Takes Shape - Building a Solid Race Foundation

On June 24, President Biden announced agreement with a bipartisan group of 21 Senators regarding what was dubbed the US$1.2 trillion "Bipartisan Infrastructure Framework". The Framework contains allocations for "physical" or "hard" infrastructure. It, however, omits major climate change measures, and does not provide for any tax increase to pay for any of its provisions. Payment for the Bill will come from tighter IRS enforcement and re-directing unspent coronavirus relief funds.

The Framework contains US$570 billion in new spending over eight years for total spending of US$1.2 trillion.

- US$312 billion will be allocated to transportation:
    - US$109 billion to be invested in bridges, roads and other major projects;
    - US$66 billion in passenger and freight rail; and
    - US$49 billion in public transit.

US$47 billion is afforded to "resilience" measures that will tackle the effects of climate change on habitats.

US$15 billion is given over to electric vehicle infrastructure with US$7.5 billion for electric vehicle charging stations.

- US$266 billion is to be directed at non-transportation infrastructure:
  - US$73 billion for power infrastructure;
  - US$65 billion for broadband infrastructure;
  - and US$55 billion for water infrastructure.

Originally, the President offered to sign the Bill into law provided other legislation dealing with child and elder care, health care and education and measures to combat climate change (human infrastructure), was also brought to him for signature. These proposals were contained in Biden's ambitious American Jobs Plan and American Families Plan.

Later, he clarified that he would sign the comparatively small Framework into law on its own given its importance and bipartisan nature. It remains to be seen whether Congressional Democrats will agree to pass the measure as a separate Bill, and thereafter attempt to secure wider objectives through much broader budget reconciliation legislation, or indeed whether a majority of Congressional Republicans will follow a bipartisan course at all.

But the markets celebrated this rare show of bipartisanship and the legislative focus on infrastructure the investment in which has powerful multiplier effects on an economy - improving mobility, increasing employment, facilitating trade and bolstering economic productivity. The S&P500 increased 0.6% to a new record closing high, with the Nasdaq better by 0.7% also to a new record.

## 4. The Post-Covid US Economy - Yellow Jersey Up for Grabs

In the US, as I write, 47.2% of people have been fully vaccinated albeit that there exist notable regional disparities. Even if vaccine uptake does not ensure herd immunity in the medium term, in many of the major cities at least, things should slowly return to normal. The US Centers for Disease Control and Prevention (CDC) announced that vaccinated persons, other than in a few designated circumstances, need not wear masks.

Should Covid-19 protocols persist, several studies have shown that an economy in which these hygiene protocols are strictly enforced experiences around a 10% diminishment in output, for reasons that we do not yet understand.

Covid-19 has left us all poorer just as it has exacerbated inequality. It is estimated by the IMF that cumulative per capita income in 2022 will be 13% lower than pre-pandemic projections in developed countries like the US, and 22% down in developing countries. In 2020, the US deployed over 20% of GDP in stimulus measures while those of developing economies deployed just 6%.

The restrictions of the Covid period have led to intense pent-up demand in the US. During the pandemic, consumers bought essentials and postponed many big-ticket item purchases and eliminated travel and leisure spend. It is estimated that US consumers are sitting on approximately US$2 to US$3trillion of unspent savings. While there is no guarantee that they will splurge, there is no doubt that a post-Covid US economy will be characterised by a return to vibrant consumerism and with it a steep recovery in US trade.

The Covid era in the US as elsewhere, has been marked by an upsurge in technological innovation (digitalisation and automation), which ought to result in a rare period of enhanced productivity after decades of productivity declines. So, in the first quarter of 2021, US non-farm labour productivity proceeded at multi-year high annualised rate of 5.4%.

One of the settings of greatest innovation has been the workplace. The phenomenon of Work From Home (WFH) took off during the pandemic, enabled by sophisticated virtual interaction technology. Studies revealed mixed levels of productivity from WFH employees. There is no consensus as to whether this workstyle will become entrenched as it detracts from the learning and innovation that occur in a real collaborative social environment. But it is clear that employers now appear more open to engage employees on the issue of flexible working. A survey by McKinsey revealed that only 10% of leading corporates expect employees to spend 80% or more of their time in the office while 80% foresee a "hybrid" workplace at which employees would spend 20% to 80% of their time.

Through history, one of the typical economic effects of pandemics has been to increase unit labour costs. This has been because pandemics like the Black Death and the Spanish Flu have decimated the working population, reducing labour supply. Covid-19 has had a dissimilar effect in sparing for the most part, the working population, and disproportionately affecting the elderly.

Nevertheless, unit labour costs are rising sharply in the US, and many positions cannot be filled. In March there existed over 8 million job openings. Several explanations for the "case of the disappearing worker" have been discussed. One, is that the Covid relief package and subsequent income supplements have disincentivised recipients from returning to employment. Second, remote work requires more elevated skills, a fact serving to exclude many workers and allowing those who are adequately skilled to bid up the price of their labour. Third, many people left the workforce during Covid and it is unclear whether they will return.

The efforts of frontline healthcare and essential workers, who at great risk combatted the pandemic and kept the US economy functioning will not have gone unnoticed. Higher wages for these groups of workers could become a political issue, placing pressure on the federal and state governments to respond. Already, it is apparent that some US employers are having a rethink on wages, particularly in respect of the lowest paid jobs.

The issue of wages feeds directly into the broader question of whether a post-Covid US economy will be characterised by more inflation than was the case before Covid.

In April and May, the Federal Reserve's preferred measure of inflation topped 3%, normally a level at which rates are raised to appropriately tighten financial conditions. But the Fed is convinced that the higher inflation readings of late are "transitory".

Before the Fed can move to raise rates, it has to taper its vast asset purchase programme, which it will do after several months of strong job growth. Thereafter the Fed will allow the US economy to run a bit hot before lifting rates probably in 2023.

A bit of inflation is obviously good for an economy for it prevents entrenching the view that price gains will be weak or non-existent. Consumer behaviour changes under these circumstances. But too much inflation erodes the value of money and impacts investment and spending.

There are indications that structural factors are at work lifting prices as well. We discuss these in detail in section 2 above.

For businesses, facing what promises to be a bumper economic cycle, fixed investment has been lifted considerably. Presently, capital investment in new plant and machinery as well as software and R&D is rising at a 15% yearly rate in the US. And it is estimated that by 2022, S&P500 companies will on average be undertaking 10% more capital spending.

The post-Covid US economy will be characterised by huge fiscal deficits. This is not just about Covid relief, which has sparked deficit spending all over the world even in economies where fiscal austerity is normally practised, but a function of the changed political reality in the US.

**The longer-term effects of these developments are, however, completely unknown. One cannot rule out very high inflation further along the post-Covid economic timeline.**

All this is to say that higher levels of growth will mark the immediate post-Covid period in the US. The Atlanta Fed's GDPNow model sees a GDP growth rate of 8.3% in the second quarter and the forecasts for the US calendar year growth rate range between 5% and 7%, before economic growth returns to trend at around 1.8% to 2.01%.

## 5. The South African Economy - Recovering from a Serious Crash

South Africa's economy grew 4.6% quarter-on-quarter annualised in Q1 2021. This followed downwardly revised growth of 5.8% quarter-on-quarter annualised in the fourth quarter of 2020. But on a year-on-year basis South Africa's economy shrank a full 3.2% from Q1 2020 to Q1 2021.

The principal drivers of growth in the first quarter were mining, finance and wholesale and retail trade. Mining alone contributed 1.2% percentage points to the headline number. Household final consumption expenditure expanded at an annualised pace of 4.7% in the first quarter with pent-up spending on clothing and footwear being unleashed. Gross fixed capital formation, however, decreased at an annualised rate of 2.6%. The main contributors to the decrease were machinery and equipment.

The South African economy at present is only back to levels of output seen in Q1 2016. Clearly, we have some way to go to get back to pre-Covid levels and beyond.

South Africa turned a trade deficit of R4.4 billion in Q1 2020 into a surplus of R147.8 billion in Q1 2021 in the main due to the exports of metals and minerals like iron ore, platinum group metals, gold and chromium. The outsize current account surplus of R267.3 billion in quarter one together with growing global investor risk appetite has helped the rand strengthen appreciably against the US dollar YTD (plus 5.0%) as well as against the currencies of its other leading trading partners.

At the May meeting of the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) the benchmark repurchase rate was unanimously held unchanged at 3.5%.

The Committee noted recent higher global inflation and greater uncertainty about the level of interest rates, particularly in the US.

The MPC revised up its forecast for SA growth for calendar 2021 to 4.2% from a prior 3.8%. This reflected better sectoral performance and more robust terms of trade. Growth in 2023 was projected at 2.3%, accelerating to 2.4% in 2023.

While high commodity prices would mean greater income for the country, and further while household expenditure was expected to be healthy as the economy re-opened, getting back to pre-pandemic output levels would take time. On the inflation front, the MPC foresaw an average CPI rate of 4.2% for 2021, down from a previous 4.3%, then elevating to 4.4% in 2022 and 4.5% in 2023, both of which forecasts were unchanged.

Input costs were rising around the world. The MPC predicted domestic petrol price inflation of 12.5% for 2021 and electricity price inflation of 10.6% for the same period. But the Committee noted that a stronger exchange rate, moderating unit labour costs, and considerable resource slack would temper the influence of such price rises. Overall, however, risks to the inflation outlook lay to the upside.

## More generally economic and financial conditions would remain volatile.

The task of the SARB would be helped immeasurably by the government pursuing macroeconomic policies that would achieve a stable public debt level, increase the supply of energy, moderate administered price inflation and keep wage inflation low into the recovery.

**The Quart is adjourned**
**By order of the Judge (GPP)**

The views and opinions expressed in this article are those honestly and genuinely held by the author. They are based on an analysis of information available in public domain. They are not intended to be, neither should they be construed to be, financial advice of any kind, nor as a definitive analysis of any financial or related issue. Individuals must not rely on this information in order to make an investment, financial, trading or like decision. If they nevertheless choose to do so, they do so entirely at their own risk.

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