

THE QUART 401FO

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

Quarter Four 2021 in Review

Introduction

Welcome to the final edition of The Quart for 2021. We hope you have managed to have a good festive season with valuable time spent outdoors with friends and family.

2021 was a year that delivered many challenges to all of us, and it is quite amazing to think that we begin 2022 with Covid-related issues still very much to the fore. Will Omicron be the last of the variants? What awaits us and what impact will the virus have on us and the world economy over the coming 12 months? The Judge covers the last quarter of 2021 in some detail, and you will note the themes of 'inflation' and 'interest rate hikes' appearing more frequently in the commentary.

The last 12 years since the Global Financial Crisis (GFC, 2008) have been characterised on a macro-economic level by low to negative interest rates and low levels of inflation. Investment professionals and traders entering the world of financial advice, banking, private equity, real estate, and fund management out of university/college in 2009/2010 in their mid-twenties are now approaching their forties and have never seen an economic cycle in which inflation is prevalent and interest rates set to rise or already rising. What will this group make of these two phenomena and how will they navigate their way through these uncharted waters?

[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 stage is set for a new set of macro-economic trends, and we need to be prepared to adapt our investment strategies and revisit our risk/reward and return expectations. The Osrin Group is constantly reviewing client portfolios and asset allocations with a close eye on the various investments we and our clients invest in. We believe that the changing economic cycle will deliver both winners and losers in the months and years to come and we hope to be able to guide our clients sensibly through the transition phase in line with their risk/reward criteria.

We continue to look for new investment opportunities and to uncover investments that offer value in this environment.

The market faces a fair amount of uncertainty what with continued Covid challenges as well as geo-political risks such as Russia threatening to invade the Ukraine and the Chinese continuing to threaten to invade Taiwan and contesting strategic islands in the South China Sea. Will Biden's Democratic Party get trounced in the mid-terms, will Boris be there to host the next party at no. 10 and will Rassie be allowed back onto the field as a waterboy?

We hope you enjoy this edition.

A handwritten signature in black ink that reads "Jonathan & Bernard". The script is fluid and cursive, with the ampersand being a simple loop.

OSRIN GROUP

The Quart is in Session

Market Activity – Quarter Three 2021

The fourth quarter (Q4 2021) was characterised by yet more strength in US stocks, particularly in the non-tech space.

But there were bouts of periodic weakness. Weakness, for example, was seen from October 8 to 12 on the back of soft labour market data. On November 10 shares reversed due to strong inflation data. Thursday November 25th was the worst day of the year with the Dow Jones Industrial Average (DJIA) lower by 905 points or 2.53%, the S&P 500 off 2.27% and the Nasdaq Composite down 2.23% after a new COVID-19 variant, Omicron, was identified. The sell-off continued on November 30 on the back of what were seen as hawkish comments by Fed Chairperson Powell. The selling was sustained into December as the first Omicron case was identified in the US. Stocks fell again ahead of the Fed meeting December 15, but rallied even as the Fed set out a rate hike timeline for 2022. The negative reaction to the Fed decision was delayed to Friday December 17, when the Dow tumbled over 500 points. Omicron fears coupled with concern of a too precipitous Fed led to stocks falling again on Monday December 20. But, the last trading week of the year saw stocks rebound sharply with the DJIA and S&P hitting new records and ending 2021 just shy of all-time highs.

As is evident stocks were influenced by two major factors, the onset of the Omicron variant and the action of the Federal Reserve in response to inflation concerns. Omicron fears were disproportionately felt among cyclical stocks such as industrials, resources and consumer discretionary because the variant threatened broader economic activity. Inflation and Fed worries were experienced more by smaller technology stocks that perform less well in a high inflation environment and are more reliant on capital markets.

For the year, the DJIA added 18.75%, the S&P surged 26.89%, while the Nasdaq Composite elevated 21.39%.

Here in South Africa, the FTSE/JSE AllShare Index (Alsi) rose 24.07% for the year, while the FTSE/JSE Top40 Tradeable Index (Top40) increased by 23.30%. Local returns were extremely positive in comparison to those of broader emerging markets (EM's). For example, the MSCI EM Index lost 4.5% in the year.

In 2021, the South African Rand depreciated 9.3% against the US dollar. Brent crude meanwhile shot up 53.1% and copper was higher by 25.5% for the year. But gold dropped US\$70/ ounce to US\$1,829.44/oz.

Quarterly Themes

1. Omicron - troubles in the field

As indicated, November 25th was the worst day for US stocks in 2021. The DJIA was lower by over 1,000 points at session lows. The move was precipitated by an announcement by the World Health Organization the previous day of a new COVID-19 variant, which it named Omicron, that had first been sequenced in South Africa. The variant had a number of mutations to the spike protein, the part of the virus that binds to human cells. The initial concern was that Omicron would be more resistant to current vaccines. The prospect of another COVID-19 wave in circumstances where there was less or little vaccine protection requiring extensive lockdowns, sent stocks linked to the US and global economy sharply lower.

Shortly after it was identified, Omicron was assessed to be far more transmissible than the Delta variant. Nothing was known about its lethality at this point, but those in South Africa who were first

identified as being infected had overwhelmingly displayed mild symptoms. Countries rushed to impose travel restrictions on Southern African countries in order to slow the spread of the variant.

On Monday November 29th stocks in the US rebounded somewhat after President Biden ruled out further lockdowns, but selling resumed on the Tuesday with the DJIA lower by 650 points. On Wednesday December 1, US averages fell sharply again, after the first case of Omicron was identified in the US. The following day saw a rebound in US stocks as evidence began to mount that Omicron symptoms were milder than the Delta variant. By the Friday cases of Omicron had been detected in five US states and in 10 European countries and stocks fell again.

Over the weeks that followed more was learned about the new variant. It was far more transmissible than Delta, but produced less severe symptoms. Existing vaccines provided cover but not as much cover as they did against Delta. Boosters were required. And new anti-Omicron vaccines are on the way. The principal concern was that due to Omicron being so contagious many employees and customers were getting sick and isolating, resulting in economic destabilisation and further complications for already entangled supply chains. In addition, given the sheer volume of cases Omicron, though more benign, was still producing a high number of severe cases among the unvaccinated resulting in a strain on healthcare infrastructure in certain jurisdictions.

Omicron is already the dominant Covid variant in most parts of the world and might end up becoming an endemic flu-like disease against which people will require annual vaccinations. That is the hope. But before this outcome is achieved there will be a good deal of economic disruption as more people are forced to isolate and economic activity is curtailed.

Future market sell-offs due to Omicron concerns cannot be ruled out, nor indeed the possibility of yet another Covid variant emerging.

2. The US Federal Reserve - An Improving Run Rate

In the minutes of the Federal Open Market Committee (FOMC) meeting of 21-22 September, members noted that the US economy had made further progress to achieving price stability and maximum employment, and that if progress continued broadly as expected, a moderation in the pace of asset purchases (US\$80 billion a month in Treasuries and US\$40 billion per month in mortgage-backed securities) may soon be warranted. The taper would be moderate in nature, starting off with US\$10 billion/ month in Treasury securities and US\$5 billion/ month in mortgage-backed securities. The target date to ending the quantitative easing (QE) programme would be mid-2022. The minutes showed that several FOMC members favoured tapering at a more rapid rate.

The FOMC met again on November 2-3. The Committee noted that inflation remained elevated due to factors that were 'expected to be transitory'. The Fed in stepping away from the term 'transitory', was giving effect to concerns that inflation had been more robust, widespread and more persistent than at first acknowledged, and that prices were expected to remain elevated into 2022. Price elevation was still seen as a result of dislocations occasioned by the pandemic.

In light of substantial further progress to achieving the Fed objectives of price stability and maximum employment, the FOMC announced that from November the Fed would be purchasing US\$70 billion per month in Treasury securities and US\$35 billion per month in agency mortgage-backed securities. Beginning in December, the amount of Treasuries acquired by the Fed would drop to US\$60 billion and the amount of mortgage-backed securities would be lowered to US\$30 billion. This all meant that the QE programme would be fully tapered by mid-2022 because similar monthly reductions in acquisitions would likely be appropriate in the months that followed. The taper timetable was not set in stone, however. The Committee could further adjust the pace of purchases depending on the economic outlook.

In his press conference, Chairperson Powell stated that the Fed was committed to a longer-run goal of 2 percent inflation and to having longer-term inflation expectations well anchored at this goal.

But if the Committee was to see signs that the path of inflation, or longer-term inflation expectations, was moving materially and persistently beyond levels consistent with the price stability goal, it would use its policy tools (rate hikes) to preserve price stability. The Fed would be watching carefully to see whether the economy was evolving in line with expectations.

The QE taper was well signposted by the Fed and there were no market ructions on its announcement. After the press briefing the fed funds futures market was pricing in a rate hike in July 2022, another rate rise in that year and three in 2023.

The FOMC met again 14-15 December. In the policy statement, the Committee dropped the term “transitory” altogether, noting that “supply and demand imbalances related to the pandemic and the reopening of the economy continued to contribute to elevated levels of inflation”. The attachment to the term “transitory” in circumstances of persistent inflation was clearly creating credibility problems for the Fed.

The FOMC indicated that from January the Fed would purchase US\$20 billion less per month of Treasury securities to US\$40 billion per month, and US\$10 billion less per month of mortgage-backed securities to US\$20 billion per month. This further increased the pace of the taper which would, all things being equal, be wrapped up by March.

The Summary of Economic Projection accompanying the statement was instructive. The median view for US GDP in 2021 was lowered to 5.5% from a prior 5.9%. The adjustment to the median view of the unemployment rate was material. For 2021 the median view was taken down to 4.3% (previously 4.8%) and for 2022 to maximum employment of 3.5% (3.8%). The median view of the Fed’s preferred measure of price stability, the core Personal Consumption Expenditure price index was raised to 4.4% for 2021 from a prior 3.7%. By 2022 the measure was seen falling to a still elevated 2.7% and thereafter to 2.3% in 2023.

As far as the view of the fed funds rate trajectory was concerned, 10 of the 18 members foresaw three rate hikes in 2022 and two members foresaw five hikes. The precise timing of the fed fund rate’s lift-off was still unclear. For 2023 eleven members were looking for a further three rate rises. The Fed has to walk a fine line.

Any hint that policy tightening is proceeding at too hasty a pace will be felt keenly in the markets that have by now become used to ultra-relaxed financial conditions.

3. Biden’s Legislative Agenda - Resistance from The Lower Order

You might remember that in the previous quarter the US faced an unprecedented default on its debt if the debt ceiling (the amount the US government can legally borrow) was not lifted. Well, on October seven lawmakers agreed a deal to lift the debt ceiling by US\$480 billion, an amount that would enable the US government to pay its bills until December. In mid-December lawmakers passed another increase in the US debt ceiling to prevent a first-ever default. The increase this time was of the order of US\$2.5 trillion, enough to take care of borrowing needs until 2023.

On November five, lawmakers passed a US\$1 trillion bipartisan infrastructure bill. The legislation directed US\$550 billion to transportation projects, utilities and broadband. The bill included US\$110

billion for roads, bridges and other major projects, US\$66 billion for passenger and freight rail and US\$39 billion for public transit systems. The Bill was the Democrats most significant legislative accomplishment since the Covid relief legislation early in Biden's tenure. President Biden signed the bill into law on November 15. But Biden's signature Build Back Better social security and climate change legislation could not get passed in the Senate even though it had been trimmed to US\$1.75 trillion from US\$3.5 trillion. US\$550 billion is to be directed at climate programmes alone. The House of Representatives passed the legislation on November 19 but two Democratic senators have prevented passage in the Senate.

4. The Significance of Evergrande - Top-Order Collapse

The Chinese property sector comprises around 30% of GDP and is probably the largest single driver of the country's economy. When a large property developer is facing bankruptcy there are sure to be market ructions. Problems at property group Evergrande became evident in Q3 2021. The company which is engaged in 1,300 real estate projects in 280 Chinese cities, had over US\$300 billion in debt (US\$19 billion of which are international market bonds) in circumstances where Chinese property prices have soared and building has been prodigious over the past several years. Fears of a domino effect and the possible collapse of the Chinese housing market were very real all the more so because several other property developers apart from Evergrande, were also distressed. Total property development sector debt is in the region of US\$2.3 trillion or 18% of Chinese GDP. The major market reaction took place in late Q3 2021 when the S&P500 recorded its biggest one-day fall since May. But Evergrande's problems continued into Q4. On October 15 another property developer China Properties Group defaulted on US\$226 million worth of short-term bonds. In mid-October yet another property developer Sinic Holdings warned that it would default on interest payments on US\$250 million's worth of offshore bonds. On November 9 the Kaisa Group announced that it too was in trouble. On December 9, Fitch Ratings announced that Evergrande was in default.

The crisis was at one point being compared to the Lehman Brothers bankruptcy some 13 years before which saw the bottom fall out of global markets. But the analogy is a poor one. While China is unlikely to bail out the company, it closely controls the financial sector and can make provision for massive additional liquidity to ease financial conditions as well as restrict the outflow of funds from China should the company go to the wall. In addition, authorities have wide-ranging powers to restructure failing companies. Unlike the Lehman experience, China does not have an array of dubious synthetic financial products based on sub-prime mortgages. The repercussions would largely be limited to China itself where 1.4 million investors are waiting for their homes to be developed by Evergrande, a company that employs 200,000 people and indirectly creates 3.8 million jobs per year. Any default would obviously affect international bondholders as well, the number of which are quite limited. The Evergrande debacle has led investors to increasingly avoid China as an investment destination, which would account for China's poor stock market showing in 2021. And broader problems in the property sector will inevitably cause a deceleration in the pace of Chinese growth. The authorities have belatedly taken steps to curb investor speculation in property and to cool the housing sector. In data released in early Q4 2021, September Chinese house prices were shown to have remained flat on the month.

However, these efforts have come late in the day, and it is almost inevitable that another sell-off on China property sector fears will be forthcoming.

5. The SARB Moves to Tighten Policy - A High Back-Lift

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) issued a policy statement on 18 November. The repurchase rate was lifted by 25 basis points to 3.75% in a split decision. Three members of the Committee voted to increase the repo rate while two members preferred no rate hike. The SARB's own model had implied a rate hike late in 2021. This was the first rate move upward since 2018.

The MPC stated that COVID-19 remained a current risk to the domestic economic outlook along with rising inflation, weaker commodity export prices, stagnant investment, and the longer-term impact of scarring from the pandemic and the July unrest.

The Committee forecast growth of 5.2% in 2021, down from a previous 5.3%. A contraction of 2.5% was foreseen in Q3 2021, against a prior forecast of minus 1.2%, with Q4 showing growth of 2.6% (1.6% previously). Despite the downward revision, the annual growth rate for 2021 constituted a “healthy bounce-back from the economic effects of the pandemic”. For 2022, the SARB forecast growth of 1.7% with a rate of 1.8% in 2023, both forecasts unchanged from before.

The July unrest, the pandemic and ongoing energy supply constraints were likely to have lasting effects on investor confidence and job creation. High export prices were expected to fade, perhaps faster than previously expected. Very weak job creation would moderate household consumption. Investment would remain constrained by the high risk of further loadshedding and ongoing uncertainty. But the faster vaccine rollout presented some upside risk to growth. Overall, however, the risks to the medium-term domestic growth outlook were assessed to be to the downside.

Prices for important commodity exports such as rhodium, iron ore, coal and platinum had decreased in recent months, while oil prices had increased strongly. Alongside higher prices and stronger demand for imported consumer and investment goods, the commodity and oil price movements implied a smaller trade surplus. Whereas a current account surplus of 0.7% of GDP was forecast for next year, the SARB now expected a current account deficit of 0.6% of GDP. The current account was expected to be in deficit of minus 1.8% of GDP in 2023 (from -0.3%) and minus 2.5% in 2024. The Rand for much of the year, benefited from generally favourable global financial and economic conditions and strong commodity export prices. In recent months however, increased uncertainty about global inflation and monetary and fiscal policy settings, with a moderation in the terms of trade, had contributed to a weaker rand exchange rate. Since the September meeting, the rand had depreciated by about 5.9% against the US dollar and was now below its equilibrium level.

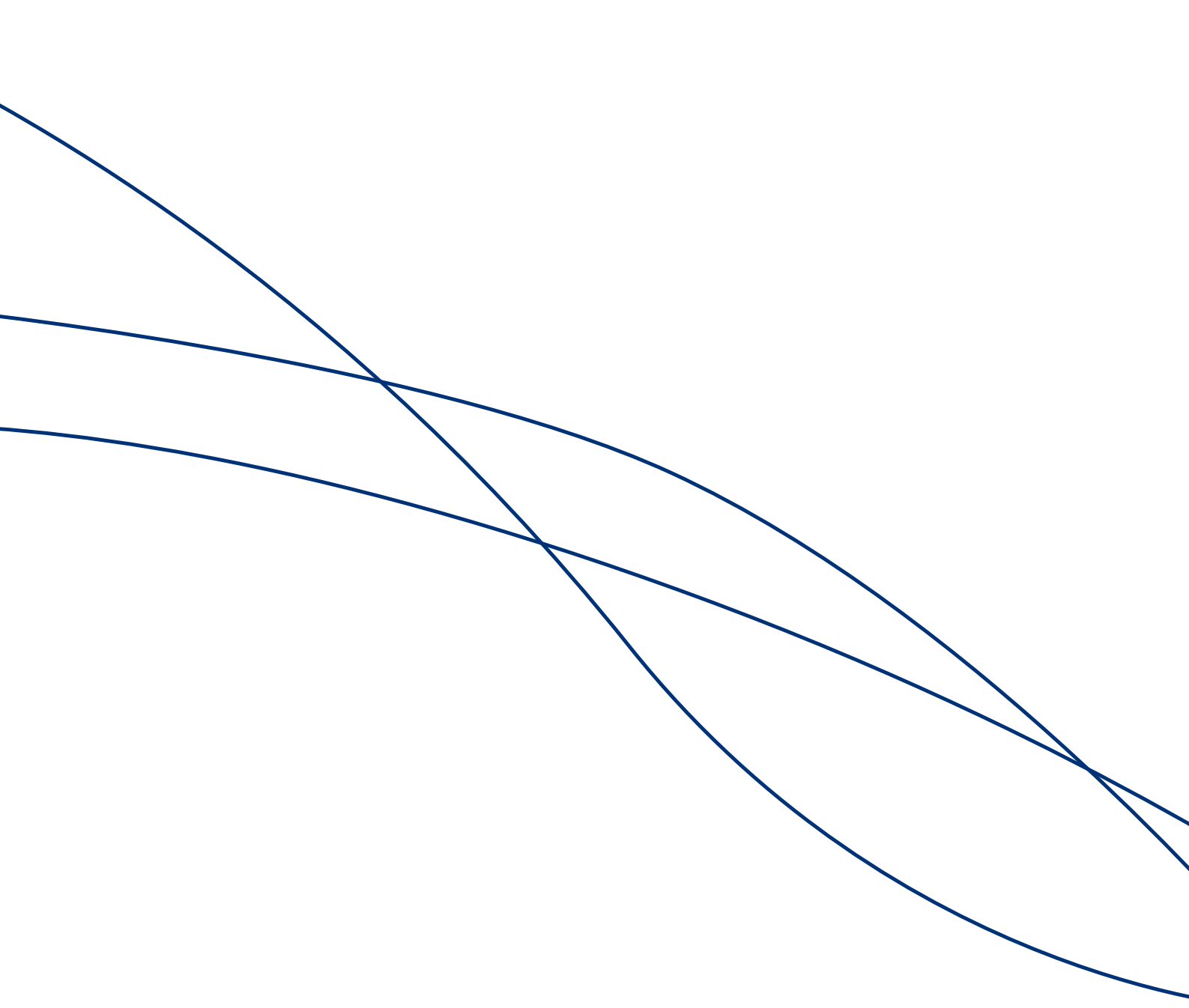
On inflation, for this year and the next two years, headline consumer price inflation was revised slightly higher, to 4.5% for 2021 (from 4.4%), to 4.3% in 2022 (from 4.2%), and to 4.6% in 2023 (from 4.5%). Headline CPI for 2024 was expected to be 4.5%. The chief contributors to higher inflation were the petrol price, electricity costs and food prices. Potential Rand weakness, higher domestic import tariffs and higher wage demands also represented risks to the inflation forecast. Overall, the risks to the short-term inflation outlook were assessed to be to the upside.

It was because inflation risks had increased and the level of current policy accommodation was seen as high that rates were taken up. And more was to come. The MPC said that given the expected trajectory for headline inflation and upside risks, the Committee believed “a gradual rise in the repo rate would be sufficient to keep inflation expectations well anchored and moderate the future path of interest rates”.

The decision came in for a good deal of criticism.

The SARB’s own inflation forecast had headline CPI well within the inflation target band of 3% to 6% for the foreseeable future. Inflation risks lay to the upside but these risks were of the cost-push variety, i.e, not a result of increased demand, and were unaffected by rate hikes. Costs were in the main a function of the strength of the rand and a rate hike of 25 basis points was not enough to strengthen the local currency. The SARB rate hike was in reality an exercise in futility and moreover dangerous at a time when so many households were suffering from the effects of the pandemic.

**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.

OSRIN GROUP

9th Floor, No2 Long Street, Cape Town, South Africa
PO Box 7256, Roggebaai, 8012, South Africa
Tel +27 21 421 7110 Fax +27 21 421 7191 Email info@osringroup.co.za

OSRIN WEALTH

Authorised Financial Services Provider **FSP No. 49766**

OSRIN ADVISORY

Authorised Financial Services Provider **FSP No. 32532**