

# THE QUART 401FO

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

## Quarter Two 2022 in Review

### Introduction

**Welcome to the Quart 2, 2022 in review. This was another bruising quarter for the global markets and the world in general with very little by way of a silver lining on any wintry cloud formations. The combination of high levels of inflation, rising interest rates, Covid lockdowns in several Chinese cities and a war in Europe, has delivered a stunning downward revaluation of all asset classes from conservative AAA grade government bonds all the way through to the crypto's.**

The questions posed by many investors include:

- Are we nearing the bottom, or is there further pain to come?
- What does the US Fed do from here?
- Which assets will benefit from an inflationary environment, which assets will suffer?
- Is it prudent to make changes to one's investment portfolio now?
- Should I sell now and reinvest when markets have settled?
- Is it a good time to add to my portfolio?

All of the above are valid questions.

**[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).

These questions are posed whenever there is a downturn in markets and while there are no simple answers to them, having lived through a number of previous market corrections, we believe the prudent approach is to remain true to one's investment strategy and wait for the economic fundamentals to settle and recover over the time horizon allocated to the respective asset class.

**Portfolios with higher equity exposure will obviously sell off to a greater degree than other portfolios. If equities are a component of one's portfolio, then accepting that markets are cyclical, one can expect valuations to recover over a market cycle which may be 3-5 years long. A lot will obviously depend on the actions undertaken by the US Federal Reserve. How do they right the ship?**

I will leave this to the Judge to expand upon in this edition.

There is a section as usual that focuses on SA, please have a box of tissues handy before commencing with "Floodlight Failure".

Please feel free to contact us should you wish to discuss or review any aspects of your existing portfolio.

We hope you enjoy the read.

All the best,  
Jonathan, Bernard and all at the Osrin Group.

A handwritten signature in black ink that reads "Jonathan & Bernard". The script is fluid and cursive, with the first letters of "Jonathan" and "Bernard" being capitalized and prominent.

OSRIN GROUP

# The Quart is in Session

## Market Activity - Conceding Early Points

US stocks continued their downward path into quarter two, driven lower by persistently high inflation and fears of over-aggressive policy response from the Federal Reserve. The Dow Jones Industrial Average (DJIA) shed 15.31% year-to-date (YTD) to end-June and around 12% in Q2 2022 alone, the S&P500 was down 20.58% (minus approximately 15% on the quarter) and the Nasdaq lost 28.51%, falling around 20% on the quarter. Every S&P sector was down for the year, bar energy. The Index traded down in 10 of the last 12 weeks. This has been the worst first half of the year for US stocks since 1970. For the DJIA and S&P it was the weakest quarterly showing since Q1 2020 and for the Nasdaq the worst quarterly performance since the dark days of 2008.

The global trend was also very negative, but emerging markets generally outperformed developed markets. The FTSE/ JSE AllShare Index (Alsi) was off 10.16% YTD with the FTSE/ JSE Top 40 Tradeable Index (Top 40) lower by 10.36% in that period. India's Sensex dropped 9%, Brazil's Bovespa retreated 4% and the MSCI Emerging Market Index was down 16% in US dollar terms YTD.

Elsewhere, European stocks were hit hard by the Russian invasion as well with the DAX30 down by 19.52% YTD and the CAC40 losing 17.2%. The FTSE 100, however, only lost 2.92% because of its high energy weighting.

The rand lost 3% in value against the USD YTD, but from its late Q1 2022 high was 14% worse off. Gold was steady but Brent crude soared 39.5% YTD.

Bonds had a brutal H1 2022 as well. Bonds are more sensitive to inflation and higher interest rates. The price on the benchmark US 10-year Treasury has fallen approximately 10% since January, a negative performance unparalleled in recent history.

## Quarterly Themes

### 1. The Fed 1 (Policy Overview) - Using a High Ball Strategy

You will remember that the Federal Open Market Committee (FOMC) of the Federal Reserve (the Fed) on March 16 raised the target range for the benchmark fed funds rate by 25 basis points (bps) to a range of 0.25% to 0.5%. This was the first rate hike since 2018 and projections were for six more 25 basis point rate rises in 2022.

In Q2 2022 the Fed radically intensified its tightening policy. Fed Governor (now Vice-Chairperson) Lael Brainard, who is traditionally a policy dove set the tone in April. She said that US inflation was "much too high" and subject to upside risks. She hinted at stronger policy action going forward, noting that the Fed was prepared to take tougher action if indicators of inflation and inflation expectations indicated that such action was warranted. She also anticipated a more rapid shrinkage of the Federal Reserve's balance sheet than that which occurred during the last recovery.

Chairperson Powell echoed these sentiments stating that a rise of 50 bps could be too small and that it was appropriate to raise rates more quickly in the here and now in order to catch up with inflation, a process known as "front-end loading".

The meeting minutes for March specified that the reduction in the Fed balance sheet (so called quantitative tightening) would in all likelihood commence in May in an amount of US\$95 billion per month made up of US\$60 billion in US Treasuries and US\$35 billion in mortgage-backed securities.

The May 4 monetary policy statement reiterated that the Committee was highly attentive to inflation risks. Inflation remained elevated due to supply and demand imbalances (extremely high demand which rose much faster than supply could meet it) brought upon by the pandemic, high energy prices and broader price pressures. The invasion of Ukraine created further upward pressures on inflation and would likely have spillover effects in the US in the shape of supply chain disruption. Covid lockdowns in China would also have the effect of further disrupting already entangled supply chains. Accordingly, the Committee decided to raise the target range for the benchmark fed funds rate by 50 bps to a range of 0.75% to 1.0%. This was the largest upward rate move since 2000.

The FOMC also announced that the Fed balance sheet would be wound down in an initial amount of US\$47.5 billion from June through August and then US\$90 billion from September. This US\$90 billion entailed US\$60 billion in US treasuries and US\$30 billion in mortgage-back securities. The process of balance sheet shrinkage encompassed not rolling over maturing securities and selling securities into the market to mop up surplus cash to create tighter financial conditions.

In his post meeting press conference Chair Powell acknowledged that inflation was much too high and occasioning hardships for low-income households in particular. Accordingly ongoing increases in the fed funds rate target range of the order of 50 bps at the next couple of meetings were appropriate. Two things occurred before the policy meeting 14-15 June. One was the Fed admission that while 75 bps hikes were currently not being considered, circumstances might demand that the FOMC go larger than 50 bps and for longer.

Second, the Fed started a discussion about the pain fighting inflation could occasion. Rate hikes were designed to cool an economy running too hot. The Fed ideally would want to constrict economic activity just as much as necessary to bring inflation closer to the 2% policy objective without overly constraining US economic activity particularly the labour market such that a recession followed. This is the ideal outcome, what is termed a "soft landing".

But over the course of 60 years the Fed managed to engineer a soft landing only three times and never when inflation was as high as it is now. In most cases policy tightening did result in a recession i.e., a "hard landing" was experienced. It was therefore hoped that monetary policy could at least be nimble enough to generate only a shallow recession that could relatively easily be navigated. In the June 15 policy decision, the Committee raised the target range for the fed funds rate by 75 bps to a range of 1.5% to 1.75%, the steepest rate hike since 1994.

A summary of economic projections was issued together with the statement. The median outlook for 2022 GDP was taken down sharply from 2.8% in March to 1.7% and from 2.2% in 2023 to 1.7%. The economy was set to return to trend growth only in 2024 according to the new projections. The headline Personal Consumption Expenditure (PCE) price index was raised to 5.2% from the March projection of 4.3%. The core PCE price index, the Fed's favoured measure of inflation was taken up to 4.3% for 2022 from a prior forecast in March of 4.1% and from 2.6% in 2023 to 2.7%.

Inflation therefore was seen not only as running higher than forecast before but was expected to be more persistent. Inflation, as Powell was forced to acknowledge, had surprised to the upside. The median projections for the path of the fed funds rate were revised sharply higher. In March the rate was seen at 1.9% for end-2022. Now the median view stood at 3.4% implying a further 165 bps in tightening before year-end. And for 2023, the rate was seen at 3.8% implying a further 40 bps in rate hikes (2.8% prior). By 2024, the rate was seen coming off to a still very elevated 3.4% from the March outlook of 2.8%.

According to the current perspective Powell suggested in his press conference that another 50 to 75 bp point hike would likely be forthcoming at the July meeting. A hike as large as 75 bps was said by Powell not likely to be a common occurrence.

In bi-annual testimony before Congress later in June, Chairperson Powell reiterated that the Fed was strongly committed to bringing inflation down. Policy would remain aggressive until compelling evidence presented itself that inflation was coming down.

The Committee consensus remained that the US economy was sufficiently strong (particularly the labour market) to withstand the projected upward policy moves, such that a soft landing could be achieved.

## Investors were not at all convinced.

The week ending June 17 was the worst week since the onset of the pandemic with the S&P500 down 5.8% in that period.

## 2. The Fed 2 (Mistakes) - Handling Errors

The principal criticism levelled at the Fed is one of timing. Simply put, the Fed stands accused of allowing inflationary pressures to build up for too long without a policy response in circumstances when they should have foreseen the current inflation crisis. This reluctance has forced it to move very aggressively late in the day to catch up. In other words, the Fed allowed itself to fall behind the curve.

Hindsight may be a perfect science, but in reality, US inflation began picking up in April 2021. It was only in November that the Fed began tapering its QE programme. But it did not move on rates. Subsequent events have indicated that it should have.

The Fed early on was still concerned with the unevenness of the recovery of the US economy. It clearly was worried that a too peremptory policy intervention would have damaged the recovery not to mention occasioned a bloodbath on Wall Street.

## The FOMC was scared of making a policy mistake as in 2013 when the so-called taper tantrum sent stock markets reeling.

These are legitimate concerns but do not absolve the Fed from reproach for not moving on rates at the November 2021 meeting. This would have allowed the Fed to be more gradual in its approach and prevented the impression that the institution is frantically trying to catch up to the problem. Instead, the Fed only appears to have taken the problem seriously from late April, when it admitted that inflation was deeper and more persistent than previously acknowledged, by which time headline inflation was running at an annual rate of 8.5% with core inflation at 6.5%, around 40-year highs.

There are counter arguments.

In any event so the argument goes, higher interest rates would not have served to make scarce energy and foodstuffs more plentiful, nor to rectify supply chain snafus, nor indeed to ramp up production capacity in China. But it would have constrained aggregate demand. And it is the robust rebound in post-Covid demand that is at the heart of the inflation problem.

Moreover, it is said that the US labour market is extremely strong and wages are rising at a near 6% pace, contributing to the inflation problem. This, it is said, gives the Fed more policy wiggle room. The countervailing assertion is that wages are growing at a rate far under that of headline inflation. And a strong economy can unravel very quickly as a result of rampant inflation, which is particularly burdensome on consumers. Inflation becomes self-fulfilling and serves to undermine consumer confidence. Consumers experience a loss of control when it is believed that price hikes have become the norm. Consumer expenditure drops off because of a lack of affordability or is front loaded leaving a dearth of spending in its wake.

For the longest time the Fed justified policy inaction by claiming that the inflation resulting from the supply-demand imbalances seen in the aftermath of Covid and the supply chain disruptions which resulted were transitory in nature and posed no systemic threat. This language was utilised time and again from the middle of 2021 even as inflation worked its way into the economy.

The Fed was in addition, susceptible to the view that the neutral rate, that level of the benchmark rate that neither hampers nor stimulates the economy (i.e., is neither contractionary nor expansionary) had for a variety of reasons fallen to around 2% to 2.5%. Many of the reasons for this phenomenon have to do with aspects of globalisation. This left the Fed ill prepared for the challenges to globalisation that were presented by the pandemic. In effect no one now knows where the US neutral rate is anymore and if it is the FOMC members' median view that the fed funds rate has to be taken to 3.8% by year-end 2023, the neutral rate appears to be far higher than prevailing orthodoxy would have it.

Another aspect of the new orthodoxy, that you can engage in massive bouts of liquidity provision as the Fed did during Covid, buttressed by trillions in Treasury fiscal stimulus without suffering inflationary consequences, is being challenged.

At least the Fed has now seized the initiative, but it will take some time before its inflation fighting credibility is restored.

It will watch the inflation data closely and will require a clear decelerating trend to ease off on policy tightening.

### 3. Russia Digs In - Formation Proves Resilient

The Russia/Ukraine conflict has settled into a war of attrition. Russian forces are amassed mainly in the east and the south of Ukraine and are subjecting Ukrainian forces to an incessant barrage of artillery shelling and rocket salvos. It is estimated that the Russians have lost up to 32% of the materiel and manpower it had at the outset of hostilities. But Russia has an almost limitless supply of both and can afford to wear the Ukrainians down. Ukraine's problem is mainly one of insufficiency of military hardware and the skills to be able to use that hardware. Ukraine is not short of manpower.

Despite the imposition of the largest ever sanctions programme against a major economy, the Russian economy is far from collapsing. The West has frozen around US\$300 billion in Russian foreign currency assets held abroad and approximately US\$30 billion in assets belonging to Russian oligarchs. Russia still has central bank reserves of over US\$300 billion. The US, Europe and the UK have imposed restrictions on purchases of Russian oil and gas, but Russia is still supplying Europe with plentiful amounts of both. Perversely these sanctions have served to dramatically increase the price of oil such that Russia can afford to discount oil to new customers like India and China. In April a million metric tonnes of oil and crude products more were shipped from Russian ports compared to March. Russia is estimated to generate around a US\$1 billion per day in oil and gas sales and even were sanctions to be fully complied with, this would only take production down by 20% or so. And they have not. For the January to April 2022 period Russia exported 14% more crude oil to Europe. In any event, there is more than enough money being generated to prosecute a war.

In addition, the West has not excluded all Russian banks from the SWIFT inter-bank messaging system such that the Russian banking system has not been totally isolated. Russia has moved to establish inter-bank messaging with Chinese banks and is primarily utilising yuan in its trade with China.

Russia is protecting its foreign currency reserves by importing less (imports from Germany were down 62.3% in March year-on-year) and by introducing exchange control regulations. 80% of hard currency that enters its economy is converted into roubles and given over to the Central Bank. Russia is also trying to compel countries receiving its oil and gas to pay in roubles. The major importers, Germany and Italy, have so far resisted the injunction.

Russia is increasingly weaponizing trade. So, in late April Gazprom announced that the delivery of natural gas to Poland and Bulgaria would be suspended. In late June Russia halved the amount of gas sent via its Nord Stream 1 pipeline that supplies mainly Germany, France, Italy and the Netherlands. Russia, to use another example, is blockading Ukrainian exports of grain that feed about 400 million people worldwide.

In one sign of weakness, the Russian stock market is about 25% off its pre-war levels but much of this can be attributed to global financial market weakness. The rouble on the other hand has held up well and is trading 16% up on pre-war levels at a 7-year high. It has almost doubled in value from its low point in March. The stability of the rouble has allowed the Central Bank of the Russian Federation to cut its benchmark rate from 17% to 14% to counter the effect of sanctions. By end May the Bank had slashed the rate to 11%. The Bank had previously instituted an emergency hike of the rate from 9.5% to 20% after the invasion. It said that it expected headline inflation of between 18% and 23% this year, but thereafter for inflation to slow to 5% to 7% in 2023.

Sanctions take time to have an effect on growth and inflation in Russia. But the IMF has estimated that Russia's economy will contract around 8.5% in 2022. The damage wrought to the global economy caused by shortages of oil, gas, coal, specific industrial metals, fertilizer and agricultural commodities will also be keenly felt, adding to worldwide inflationary pressures and central bank challenges.

In late May the Biden administration announced that it was preventing Russia from paying bondholders through US banks. Up to that point the US had allowed the Russian Central Bank to process payments to bondholders via US and international banks. In late June Russia was said to have defaulted on US-dollar and euro-denominated interest payments due in May but for which a grace period of 30 days was obtained. The Russian government actually sent US\$100 million in roubles to a settlement house, but the bonds in question arguably do not allow for the payment in roubles to be converted abroad. In any event conversion was not possible because of US bank sanctions. This was termed the first Russian debt default since 1918. But, as indicated here is some dispute as to whether the non-payment amounted to a default at all and the matter will go to the courts. A further US\$2 billion in interest payments are due in the remainder of 2022.

## 4. Loadshedding and The SA Outlook - Floodlight Failure

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) delivered a policy statement on May 19. After rate hikes in January and March, May saw a more aggressive MPC lift the benchmark rate 50 bps to bring the total rate rises during the current tightening cycle to 125 bps. Four MPC members voted for a 50 bps rise and one for 25 bps.

The Committee noted that the war in Ukraine and China's lockdown approach to Covid posed threats to global growth. Accordingly, the MPC downgraded its forecast for world growth in 2022 to 3.5% from a prior 3.7% and compared to the IMF forecast of 3.6%, and for 2023 to 2.7% versus a previous 2.8%.

South Africa as a developing country was susceptible to higher energy and food prices, trade impairments and rising debt costs. Rate hikes around the globe had tightened financial conditions and emerging economies were vulnerable to currency depreciation and capital outflows.

Last year saw the South African economy recover from the Covid pandemic, with the country posting growth of 4.9% in 2021. For the current year the MPC cut the growth outlook to 1.7% from a forecast of 2% made at the March meeting. This was due to factors such as the severe flooding in KwaZulu-Natal and electricity supply constrictions. In 2023 and 2024, the economy was set to experience GDP growth of only 1.9% hindered by loadshedding, and infrastructure and policy constraints.

On the plus side, the South African economy had experienced strength in the housing sector due to rising incomes, house prices and still accommodative financial conditions. Private investment had

proved more resilient than previously imagined and the tourism, hospitality and construction sectors ought to experience stronger recoveries in 2022.

## The risks to the growth outlook were said to be balanced.

South Africa's export commodity price basket was forecast to rise by 9.5% for the year as a whole (up from 8.0%), keeping the country's terms of trade favourable. The current account surplus was seen reaching 2.1% of GDP this year, before easing to 0.8% in 2023 and around 0.0% in 2024.

As demand recovered after the pandemic and supply shortages were experienced, the prices of many goods and commodities had increased. The Committee increased its assumption for fuel and food inflation in the current year and kept the assumption for electricity price inflation unchanged.

So, for 2022 the MPC predicted an average inflation rate of 5.9%, up from a prior 5.8% but still just within the target band due to higher energy and food costs. Inflation was seen temporarily breaching the target band to the upside in Q2 2022. For 2023 inflation was seen as decelerating to 5.0% and then to 4.7% in 2024.

The risks to the inflation outlook were assessed to the upside. Russia's war in the Ukraine was likely to persist for the rest of this year and could have significant further effects on global prices, mainly for oil, the price of which had risen sharply since the onset of hostilities. Electricity and other administered prices continued to present short- and medium-term risks. Higher diesel and coal prices could result in upward revisions to the electricity price forecast for 2023.

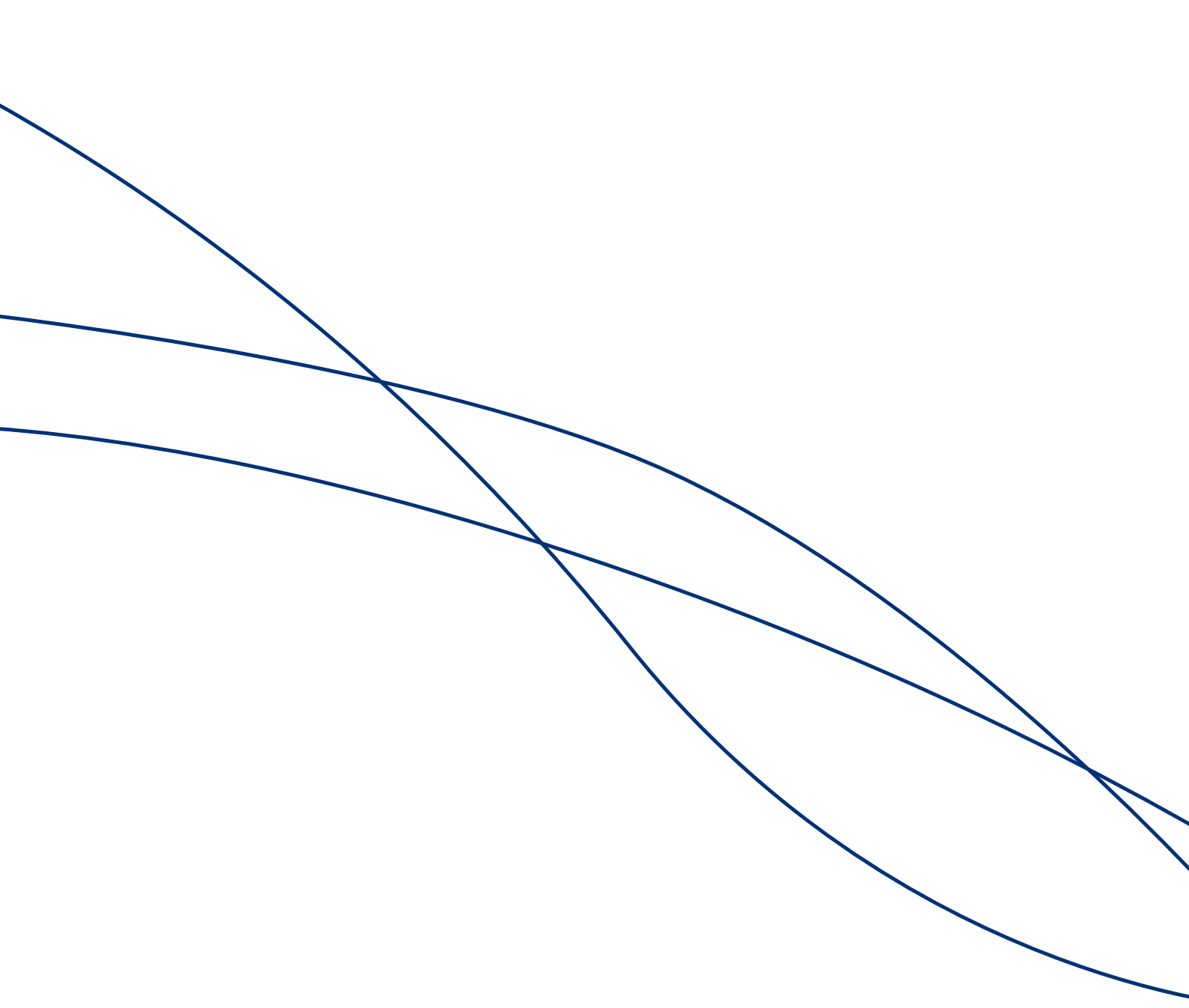
It was against this backdrop that the Committee went for a rate increase of 50 bps.

The second quarter saw loadshedding return with a vengeance. Economists are in agreement that persistent loadshedding poses severe risks for South Africa's growth outlook. Indeed, the South African economy was now seen by many as shrinking in the current quarter an outcome exacerbated by loadshedding and the KZN flooding as well as a weakening in global demand and low levels of consumer and business confidence.

If stage 4 to 6 loadshedding persisted for any meaningful duration, some economists are calling for a contraction in Q3 2022 as well, meaning that South Africa would enter a recession.

International credit rating agencies are watching developments and could move to alter their current positive outlooks on South Africa's credit rating to negative, paving the way for a ratings downgrade.

**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](mailto:info@osringroup.co.za)

### **OSRIN WEALTH**

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

### **OSRIN ADVISORY**

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