THE QUART 40IFO

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

Quarter Three 2022 in Review

Introduction

Welcome to the Q3, 2022 edition of The Quart.

The news is moving so fast these days that I almost feel like even a daily bulletin will not suffice in keeping up with developments. By way of example, just in the space of 44 days since Boris Johnson resigned/was forced out as Britain's PM, his replacement and her Chancellor have been and gone. By next week there will be another new PM – could it even be Boris? The Italians who have had 70 governments since the end of WW2 are taking offence at the fact that Britain is being compared to them. The recent headline in the Economist proclaimed, "Welcome to Britaly". It is quite amazing to see a trend of potentially returning PM's/Presidents in the US (Trump), UK (Boris), Brazil (Lula) and Israel (Bibi). If only Russia was on the list...

[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).

In the background to all the political turmoil the world economies are battling higher levels of inflation aggravated by Russia's 'special operation' in Ukraine. Putin continues to pound Ukrainian infrastructure as winter approaches. Europe will be facing a chilly few months ahead amid ever increasing inflationary energy costs.

As the Judge alludes to in the body of The Quart, it is the US Fed that holds all the cards, and we all watch carefully to see just how exactly the Fed manages to stop an oil tanker exactly on an imaginary line drawn in the ocean. Put interest rates up too much, too quickly and risk tipping economies into recession. Don't put up interest rates enough, in time and inflation continues to rise. The problem is, we will only know how the Fed has performed in 6 - 18 months' time as these rate increases filter through the economic system.

From an investment perspective the current scenario is decidedly uncomfortable. Since the beginning of the year, portfolios including most asset classes have dropped dramatically in value. Major equity indexes (e.g. S&P 500) are down approximately 25%. The world government bond indexes are down almost in line with most equity indexes. Bond markets having suffered their worst performance in 40 years. The indexes belie the fact that some companies that have become household names in investors' portfolios are down in an amount of 50% or even 60% or more. Tesla, Netflix and the like. Investors have to remember that markets are cyclical and that is why we invest on a 3 - 7-year basis.

We also have to believe that at some point, hopefully in the not-too-distant future, markets reach a level where institutional investors believe that there is genuine value to begin deploying funds once again. The Osrin Group members remain committed to staying alongside clients while maintaining a close watch on the investment managers as we all experience the journey. Having experienced a number of market sell-offs in the last 30 years (Russian government debt default, Y2K and the dot com bubble, 9/11 and the Global Financial Crisis of 2008/09), we can attest to the fact that as long as leverage in the underlying equity investments is low (strong balance sheets) and management remains intact and focused on to its mandate, the cycle will turn and with it the restoration of values.

We always remain contactable and are here to assist all our clients with all investment related queries.

In concluding we would like to share the wonderful news that the Osrin Group moved up in the world last month. While we have remained in 2 Long Street, we have moved from the 9th to the 20th floor. All contact telephone numbers, and email addresses remain unchanged. You are most welcome to visit our lovely new offices - the views are vastly improved.

Kind Regards,
Jonathan, Bernard and all at the Osrin Group.

Jonathan & Bernard

OSRIN GROUP

The Quart is in Session

Market Activity - A One Horse Race

The sell-off in US equities which saw the S&P500 post its worst first half performance since 1970, continued into Q3 2022. The major indices started the quarter well enough with a 5-day gain for the Nasdaq, but the mood soon soured as the US posted July inflation figures which were the highest since 1982. Stocks then rallied despite the Fed coming in with a hefty rate hike to end the quarter on a positive note. The Dow Jones Industrial Average (DJIA) climbed more than 6% in July, while the S&P 500 inclined 9.1%. The tech-heavy Nasdaq Composite, still the underperformer of the three this year, rose about 12.4%. July 2022 was the best month for US stocks since 2020.

August started off with a bit of selling pressure. The warning signs were there when stocks did not rally after a strong non-farm payrolls report for July. Still the S&P and the Nasdaq ended the first week of August on a positive note and the second week marked the fourth straight winning week for the S&P. Stocks had a particularly big day when July CPI and PPI inflation came in under expectations. But the mood soon soured and selling began in earnest on August 22, after a week in which the three indices lost ground. On August 26th, the major US indices all fell over 3% with the DJIA down over 1,000 points after hawkish comments by the Fed Chair, Jerome Powell. In August the Dow closed out off nearly 4.1%, while the S&P and Nasdaq posted monthly losses of 4.2% and 4.6%, respectively. By the end of the first week of September the Nasdaq was on a 6-day losing streak and the major US stock averages had fallen for three straight weeks. Although posting gains in the following week, unexpectedly high inflation numbers released September 13, saw the DJIA and the S&P lower by around 4% (the DJIA lost nearly 1,300 points) and the Nasdaq tumble by over 5%, the worst sell-off since June 2020. Stocks stabilized but never recovered. Equities had another awful day on September 23rd and again on September 26th when the S&P dropped to a new 2022 low and the DJIA fell into a bear market (20% or more lower from its latest high).

The major averages ended a brutal September all sharply lower. The S&P 500 hit a new low for the year on September 30 after the Fed's preferred inflation gauge came in hotter than expected. The index suffered its worst month since March 2020 during the onset of the Covid pandemic, down 9.3%. For the quarter the S&P surrendered 5.3% after being up as much as 14.3% earlier in July. The DJIA closed under 29,000 for the first time since November 2020, dropping 8.8% on the month. The Nasdaq gave up 10.5% in September.

Investors are clearly worried that the Fed is being too aggressive in the current tightening cycle, that it is withdrawing too much liquidity too quickly from the financial system.

For the year to date (YTD) the DJIA is down 21.48%, the S&P 25.25% and the Nasdaq 33.20%. Elsewhere, European stocks were hit hard by Russia's war with Ukraine. The DAX30 has dropped 24.38% YTD, while the CAC40 has given up 20.16% and Switzerlandís SMI has retreated 20.65%. Emerging markets continued to outperform developed markets in own currency terms. The FTSE/ JSE AllShare Index (Alsi) is down 11.99% YTD with the FTSE/ JSE Top 40 Tradeable Index (Top 40) off 14.41% in that period. India's Sensex fell 4.69% YTD and Brazil's Bovespa is actually higher by 2.74%. An obvious exception was Russiaís RTS, which has tanked 34.94% YTD. The trade weighted US Dollar Index (DXY) rose by 17.23% YTD, with the USD better by 13.42% against the South African rand.

The global market for government bonds, typically a safe-haven investment, fell into bear territory for the first time in 70 years.

Quarterly Themes

1. The Fed - Fixed Odds Rise Across the Board

The Federal Open Market Committee (FOMC) of the Federal Reserve met twice in Q3 2022.

At the first meeting in July, the FOMC raised the target range for the benchmark federal funds rate by 75 basis points (bps) to a range of 2.20% to 2.50%. This came after the Fed had already delivered 150 bps points in tightening since March 2022. The Fed referenced a softening US economy albeit that the labour market remained robust resulting in solid underlying demand. Consumer spending had deteriorated a little, and business fixed investment had slowed. Activity in the housing sector had weakened. Inflation remained elevated reflecting supply and demand asymmetry related to the Covid pandemic as well as higher food and energy prices and broader price pressures. The Fed in addition referred to the effect of the war in Ukraine in placing upward pressure on food and fuel inflation.

The Committee said it anticipated that ongoing increases in the fed funds rate were foreseen. Further, the Fed would continue with its programme of quantitative tightening which is to say the running down of its balance sheet comprising Treasury securities and agency mortgage-backed securities in accordance with the timetable set out in May. This is an important aspect of monetary policy since it serves to remove cash from the financial system.

In his press conference, Chair Powell said inflation was "much too high" and spoke of the Fed's strong commitment to bringing down inflation for which task the Fed had the policy tools and the resolve. The FOMC was acutely aware that high inflation imposed significant hardship, especially on those least able to meet the higher costs of essentials like food, housing, and transportation. The Committee remained highly attentive to inflation risks and was determined to take the measures necessary to bring inflation down to the Fed's 2% objective.

But such actions came with consequences and the FOMC envisioned a period of below-trend economic growth and a softening of labour market conditions. In effect the FOMC was saying that there would be no gain without pain. The Fed was looking for compelling evidence that inflation was moving down, consistent with inflation returning to 2 percent. In developing policy, the Fed had to be nimble and react to incoming data and the evolving outlook for the economy. Another similarly large increase in the fed funds rate might be deemed necessary at the next meeting but this would depend on the data received in the interim.

At the annual central bankers' confab at Jackson Hole, Wyoming Chair Powell picked up on the "no pain no gain" theme. He said it was likely that the Federal Reserve would have to use its policy tools more forcefully and that the central bank would have to continue to hike rates in a manner that would occasion "some pain" to the US economy. To allow inflation to take hold would cause even greater pain.

While higher interest rates, slower growth, and softer labour market conditions will bring down inflation, they will also bring some pain to households and businesses.

Fed policy was likely to be restrictive for some time, certainly for a time after a neutral rate (a rate that neither stimulates nor restricts the economy) had been achieved. Experience had shown that it was wrong to prematurely loosen policy. So even if inflation were to subside rates would remain elevated until inflation had been emphatically defeated.

At the September 20-21 meeting the Fed delivered yet another 75 basis point rate rise to a target range for the fed funds rate of 3.0% to 3.25%. In the FOMC's view inflation still remained unacceptably elevated.

Of interest was the Summary of Economic Projections released after the policy meeting. The median Committee member view for GDP growth in 2022 was slashed to just 0.2% from a June projection of 1.7%. implying a perception that the US could enter a brief recessionary period during the year.

The median view of the average core Personal Consumption Expenditure (PCE) Price Index which is the Fed's preferred benchmark inflation measure, was seen at 4.5% in 2022 (formerly 4.3%) easing to 3.1% in 2023 (2.7%) and then to 2.3% in 2024 the same forecast as in July.

As for the median view of the projected fed funds rate over time, a majority of 10 of 19 members foresaw the rate at 4.375% or higher by end-2022 implying at least another 100 basis points of lifting before this year was done. The level of the rate was seen returning to the longer run rate of around 2.5% in 2025. The days of super accommodative monetary policy appear to be over for now, until the next serious downturn that is.

Senior Fed officials including Powell and Vice Chair Brainard have used public platforms to express in no uncertain terms that the Fed was "in this for as long as it takes to get inflation down." Although it does not sit well with markets, this tough talk is a form of policy tightening as well without actually moving on rates because it is aimed at bolstering the Fed's inflation fighting credentials and preventing households and businesses from starting to expect inflation to run well above 2% in the long run which would make it that much harder for the Fed to do its job.

The Fed only started using the fed funds rate as a policy lever in 1982 but if the Fed's own forecasts are to be believed then this will be the fastest and steepest tightening cycle in forty years.

2. The "R" Word - A Photo Finish

The US entered a recession in Q2 2022 according to the third and final GDP estimate released late in September. The technical definition of a recession is two consecutive quarters of contracting growth. And the GDP report in question showed that the US economy contracted 0.6% quarter-on-quarter annualised after a 1.6% contraction in the first quarter. Negatives during the quarter were a drawdown in retail inventories, residential fixed investment, government expenditure and net imports. By sector, construction activity shrank the most, followed by manufacturing, wholesale trade and agriculture. On a year-over-year basis the US economy expanded 1.8%.

The reason the figures were not greeted by much fanfare was that the recession was merely technical. A technical definition exaggerates base effects, which is to say that the US was coming off very high post-Covid growth numbers (+1.7% in Q4 2021), which was not sustainable. In addition, the negative number was driven by peripheral phenomena not intrinsic to economic well-being. So, if it was not for the drawdown in retail inventory investment the US would actually have posted positive growth for the quarter. Critically, consumer spending on services accelerated in the second quarter and outpaced the slowdown in expenditure on goods during the period. Consumer spending makes up 70% of total US GDP.

The arbiter of whether the US has entered a recession lies with the National Bureau for Economic Research, a non-profit research group. It defines a recession as "a significant decline in economic activity spread across the market, lasting more than a few months". It is thought that the NBER uses six key factors to determine whether or not the US is in recession:

- real personal income minus transfer payments
- non-farm payrolls
- employment as measured by the Bureau of Labor Statistics' household survey
- real personal consumption expenditure
- sales adjusted for price fluctuations; and
- industrial production.

The emphasis is on depth, diffusion and duration.

So, the US economy would have to show signs of a significant decline in economic activity spread right across the economy and lasting more than a few months for it to be considered to be in a recession. At the time of writing the US is generating well over 300,000 jobs per month with 526,000 nonfarm payrolls created in July. The unemployment rate is a mere 3.5%. which is close to full employment. There are still twice as many job openings as there are candidates to fill them. And jobless claims in September fell to a five-month low. Household finances are also still relatively strong. So, any suggestion that the US is in a real recession is quite laughable at this juncture. Further, while the pace of US retail sales has decelerated somewhat, they are still growing month-on-month. There has only been one down month for retail sales out of the last eight.

But that is not to say that increased interest rates from the Fed will not lead to a recession. Indeed, judging by the decline in bond and equity markets the scale and rapidity of interest rate hikes in the US will in all probability take the US into a full-blown recession down the line, albeit that the recession could be mild and short-lived. It is extremely difficult for central bankers to find the right balance between fighting inflation and preventing a recession. A key indicator here would be a rise in the unemployment rate and a deterioration in labour market activity.

Rising interest rates work to de-stimulate the economy by compelling firms to charge more for their goods and services and quelling labour demand. On the demand side rising rates lead to lower consumer demand and firms investing less.

A rough and ready indicator of the likelihood of a recession is bond yield inversion, which occurs when shorter dated bond yields rise above the rates of longer dated bonds. That is happening at present with the US yield curve where the yield on the 2-year Treasury is around 4.2% and that of the 10-year Treasury is just above 3.8%. But yield inversion although a popular signifier of a future recession is far from infallible. There have been many occasions where yield inversion has not led to a recession.

One area of real concern at present is the state of the US housing market which is demonstrably in a recession. Existing home sales are falling to multi-decade lows and prices decelerating at their quickest pace on record, albeit still up year-on-year. Homebuilder confidence has also declined markedly. Rising mortgage rates are simply making houses unaffordable.

Another area of concern is consumer confidence. The University of Michigan consumer sentiment survey is hovering near 50-year lows.

But if you want to know whether or not the US has entered a recession pay attention to labour market data.

3. The UK After Boris - Finishing Out of The Money

Boris Johnson's government finally collapsed in early July after he was yet again found to have lied, this time about his knowledge of the improprieties of the Conservate Party's deputy Chief Whip. This followed multiple instances of misrepresentation concerning illegal lockdown parties held at Number 10 for which Johnson was fined. On July 5, two key cabinet ministers resigned followed by the resignation of about 50 ministers and aides. By June the 6th the game was up. Several candidates put their hats in the ring for the PM's job, but the choice soon crystallised around the Chancellor of the Exchequer Rishi Sunak and the Foreign Secretary Liz Truss. Truss won the backing of the party rank and file by about 20,000 votes.

The economy inherited by Truss is frankly in a state of disrepair. The country growth rate is about 40% lower than it was in the decade leading up to the financial crisis of 2008. Growth in 2023 is expected to be the worst of the G7 countries. Productivity is low. The Bank of England was forecasting CPI inflation of 13% down the line, and the pound has struggled across the board but especially against the US dollar. When Truss took office, a pound could buy just US$1.19, down from around US$1.40 in January. Sterling's weakness was driving up the cost of imports. To add to consumer woes the soaring price of fuel and gas had led to a cost of living crisis which urgently required addressing. Furthermore, the terms of Britain's exit from the EU, most notably the provisions of the Northern Ireland protocol had been illegally disavowed by the British government leading to frictions with Brussels and threatening EU-UK trade. Goldman Sachs warned of an impending recession.

British Consumer confidence is at a 50-year low.

A graduate of Oxford, with experience in economics Truss styled herself as a Thatcherite conservative, a believer in unfettered economic liberalism and small government, unwilling to give what she terms "hand-outs" but eager to radically cut taxes and spending to stimulate economic growth. Tax cuts, so the argument goes, pay for themselves via the trickle down of the benefits of the growth they engender. She also promised to review the Bank of England's independent mandate.

On becoming prime minister Truss' first order of business was to pick her cabinet. She chose Kwasi Kwarteng as the new Chancellor of the Exchequer. Kwarteng is also noted for his free marketeer, low tax approach to growth. His first move was to sack Tom Scholar the experienced Treasury civil service head. He also indicated he would target trend growth of 2.5% per annum.

Her second order of business was oversight of the Chancellor's mini-budget delivered to Parliament. It was a speech that lasted all of 25 minutes but one the Economist called the "biggest fiscal intervention" by any Chancellor in the last 50 years. He announced a plan to spend £60 billion in the six months from October to reduce energy bills for households and businesses. Simultaneously he announced that the basic rate of income tax would be cut to 19% from 20%. A planned corporate tax hike to 25% would not now go ahead with corporate tax remaining at 19%. Taxes on those earning over £150,000 would be slashed to 40% from 45%. Kwarteng said that government expected to have to raise another £70 billion in debt (or 3.2% of GDP) over the remainder of the financial year, with more borrowing in sight after that. The announcement came just as the Bank of England had lifted rates for a seventh time to try and neutralise inflation. What was not needed was more largescale fiscal stimulus paid for by more borrowing.

The sheer scale of the tax cuts to be funded by additional borrowing was perceived by the markets as having the potential to destabilise Britain's fiscal position, and almost immediately the pound fell by 3.5% versus the US dollar and bonds were sold off aggressively with yields on the 2-year gilt hitting their highest level since October 2007, and yields on the 10-year gilt reaching a level not seen since 2010. It was the biggest one day rise in 10-year yields since 1998. Some mortgage lenders were forced to stop issuing loans.

Simply put, investors did not believe that Britain could finance its burgeoning deficit given the economic backdrop. The Institute of Fiscal Studies estimated that tax cuts would increase the UK's debt to GDP ratio from an already imposing 80% in 2021-22 to nearly 95% in fiscal 2026-7. Sterling continued to weaken to US$1.0350, a new historic, multi century low (to be fair the US dollar was only de-pegged from sterling in 1971).

Matters became so dysfunctional that the Bank of England announced it would temporarily scrap quantitative tightening (selling of bonds) until end-October and adopt a two-week short-term programme of quantitative easing (bond buying) on whatever scale was necessary to stabilize the gilt market. Purchases would focus on the long end of the curve. Of course, this will only intensify inflationary pressures, precisely what the BoE has been fighting to contain. The Treasury was quick to offer its support and the Chancellor talked up the importance of an independent Bank of England.

If there is a lesson here for Truss it is that it is worth paying heed to market warnings (and there were many ahead of the controversial mini-budget) if you want to remain in power. During the gilt crisis polls showed that Labour led the Conservatives by 17 percentage points and rumours of Truss' possible replacement were rife. Treasury's further elaboration of the details of its growth plan scheduled for November 23 will have to be brought forward. Investors hope that salutary lessons have been learned.

4. South Africa - Into the Home Stretch

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) met twice in Q3 2022, once in July and once in September.

In July, the MPC lifted the benchmark repurchase rate 75 bps to 5.50%. It was a split decision. One MPC member wanted a hike of 100 bps, while one preferred a 25 bps rise. Three opted for 75 bps. The rate hike took total SARB rate tightening in the current cycle to 200 bps.

In September the SARB lifted the repurchase rate by 75 bps to 6.25%. It was a split decision. Two MPC members preferred a 100 bps rise, while three went for 75bps. This brought the cumulative amount of tightening to 275 bps in the current cycle.

The MPC reduced its outlook for global growth in 2022 to 3.0% from a previous 3.3% and in 2023 to 2.0% from a prior 2.5%. For South Africa the MPC revised its 2022 growth rate outlook to 1.9% from 2.0%. In the second quarter the local economy had contracted 0.7%, which was not as bad as initially foreseen. The South African economy was seen expanding 0.4% in Q3 2022 down from 0.7% previously and 0.3% in the final quarter of the year. For 2023 the domestic economy was seen expanding at a rate of 1.4% in 2023 and 1.7% in 2024, above prior forecasts.

After revisions, the risks to the medium-term domestic growth outlook were assessed to be balanced.

While negative global shocks and loadshedding would continue to create headwinds to growth, household spending and investment were more supportive.

South Africa's export commodity price basket had come down from earlier peaks and was now forecast to rise by 2.3% for the year as a whole (down from a prior 3.2%), before falling in 2023 by about 17.6% and by a further 10.0% in 2024. As a result of these developments, the current account balance was expected to register a surplus of only 0.2% of GDP this year, before falling to a deficit of 1.0% in 2023 and 1.6% in 2024, a much weaker outlook than conveyed at the July meeting.

Inflation continued to surprise to the upside despite the global growth slowdown. While the SARB revised down the outlook for fuel price inflation to 33.7% for this year and for electricity price inflation to 10.9%, it ramped up food price inflation forecasts to 8.1% in 2022 from a previous 7.4%.

The Bank's forecast for average headline CPI inflation for 2022 was kept unchanged at 6.5%. For 2023, headline inflation was revised lower to 5.3% (from 5.7%), as a result of lower food price inflation and to 4.6% in 2024 (from 4.7%).

The risks to the inflation outlook were assessed to lie to the upside.

While global producer price and food inflation had eased, Russia's war in the Ukraine continued to have adverse effects on global prices. Oil prices had increased strongly from the start of the war, to around US$130 per barrel, and might rise again from the current level as stresses in energy markets intensified. Electricity and other administered prices continued to present medium-term risks. Given below-inflation assumptions for public sector wage growth amid high petrol and food price inflation, considerable risk still attached to the forecast for average salaries.

The MPC reiterated that headline inflation, which breached the target range in Q2 2022 was expected to remain above the band until the second quarter of 2023. By the fourth quarter of 2024, it was expected that headline CPI would revert to the mid-point of the target range.

During the third quarter President Ramaphosa paid an official working visit to the US at the invitation of President Biden. Ramaphosa also met with Vice-President Kamala Harris.

The two presidents talked extensively about trade and investment and there was agreement on the need to create a more attractive environment for American companies to invest in South Africa, where an estimated 600 US companies were already doing business in a range of sectors. A joint task force on trade and investment would be established to expand bilateral economic ties. In 2023 South Africa would host the African Growth and Opportunity Act (AGOA) Forum which would map the next phase of Africa-US trade.

President Ramaphosa took the opportunity to express South Africa's concerns about tariffs levied by the US on South African steel and aluminium products, which South Africa viewed as unfair and punitive. Global security and stability discussions focused on the insurgent attacks in Mozambique. President Ramaphosa acknowledged the assistance currently being provided by the US in responding to the insurgent threat in Mozambique. President Ramaphosa called for more US support in the provision of skills and resources to counter terrorist activity that was causing suffering in Mozambique and threatened the stability of the SADC region.

Other areas of discussion included the transition to a green economy, food security in Africa, United Nations reforms, and building capacity of the South African state.

Loadshedding continued unabated during the quarter. One economist estimated that stage 6 loadshedding cost South Africa R4 billion daily, and another that the South African economy was between 8% and 10% (R360 billion to R460 billion) smaller than it could have been but for loadshedding. This had resulted in a substantial loss of job opportunities.

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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