

THE QUART 40IFO

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

Quarter Two 2023 in Review

Introduction

As we hit the halfway mark of 2023 - Christmas shopping days' countdown has already begun - we look back on a chaotic six months of geopolitical stresses and strains around the globe. Financial indicators and measurements have also surprised on several levels. Sharp spikes in global interest rates have been implemented by almost all countries' central banks to counter high levels of global inflation. In Q1 and Q2 of this year, the feeling was that interest rate rises would bring inflation levels down and that rates could start coming off by year end. Now, it seems that inflation is proving to be rather more 'sticky' than first thought and the higher rates of interest may need to go even higher and perhaps only reduce towards the end of Q1 or Q2 2024.

[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 war in Ukraine and Russia's bombarding of grain, barley and other commodity warehousing in Odesa threatens to keep commodity prices high while Europe is successfully managing to pivot away from its dependence on Russian oil and gas.

On the political front, US elections looming, the Tories on a hiding to nothing in the UK, Israel in chaos and SA flirting with Russia makes for interesting times. The Chinese growth numbers - always an important gauge for global economic growth - have disappointed to the downside and China is now trying desperately to stimulate growth from domestic consumption. Their power broking skills are also growing day by day as the US becomes less relevant on the global stage. Time to learn Mandarin?

In this edition, the Judge provides a detailed look at:

- the current and forthcoming moves by the Federal Reserve whose interest rate policies set the investment bar for all of us;
- an interesting overview of the "debt ceiling" negotiations which took the US to the brink once again;
- and how the SARB is managing its way in the higher interest rate and continuing loadshedding environment.

The Osrin Group continues to closely monitor the investment landscape and keep a keen eye out for investment opportunities that will present themselves as a result of the rise in rates. We believe that the sharp rise in interest rates to elevated levels will create opportunities in certain sectors. For example, what do all the people who come off very low fixed mortgages in the UK do when they are now presented with 3x higher mortgage rates? What is the impact on the overall housing market there? Does one jettison the pound? If so, which currency looks like a sound bet?

For now, with offshore money market funds paying reasonable rates of interest, we believe it prudent to keep some "powder dry" while economic policies remain unpredictable in the short term and opportunities begin to present themselves.

We remain at your service and hope you find this edition of interest.

Warm regards
Jonathan and Bernard

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 – The Half Time Whistle Blows

Major US indices have had banner years to date led by big cap, high quality tech stocks. Investors appear unfazed by the Fed's tightening regime so long as the US labour market remains robust and a recession looks like it can be avoided.

The S&P 500 put on 6.5% in June for its best monthly performance since October. The Nasdaq Composite was up 6.6%. Both indices recorded a fourth consecutive positive month. The Dow Jones Industrial Average (DJIA) rose 4.6%, for its best month since November.

For the second quarter the S&P climbed 8.3%, marking a third straight quarter of gains and its best quarterly advance since the fourth quarter of 2021. The Nasdaq surged 12.8% in Q2 2023 and in so doing registered two successive quarterly gains. The DJIA rose a more sedate 3.4% marking a third straight positive quarter.

For the first half the S&P 500 jumped 15.9%, its best first half since 2019. The Nasdaq rocketed 31.7%, for its finest first half since 1983. The DJIA notched a more modest gain of 3.8%. The three major averages also registered winning weeks, with each putting on over 2%. In Europe the German DAX30 was better by 14.8% year-to-date (YTD), while the French CAC40 improved 12.1%. The FTSE100 by contrast surrendered 0.3% in the first half. The Nikkei 225 meanwhile put on 29.1%.

Amongst emerging markets YTD Brazil's Bovespa ramped up 15% while Russia's RTS Index recorded a gain of 2.1% and the Shanghai Composite was up 2.1%. Here at home, the FTSE/ JSE AllShare Index (Alsi) gained 4.1% for the half and the FTSE/ JSE Top 40 Tradeable Index (Top 40) added 3%.

The USD appreciated 10.2% against the ZAR in H1 2023 with the local currency hit by loadshedding and US concerns over South Africa's policy stance on the war in Ukraine. Gold was a good performer improving by 5.3% YTD.

Quarterly Themes

1. The Fed – a water break

Going into Q2 2023, the Fed was of the view that more rate increases lay ahead to keep inflation on a sustained downward path to 2% and inflation expectations well anchored. Precisely how much higher the fed funds rate would need to go and for how long policy would need to remain restrictive would depend on how much inflation and inflation expectations were moving down, and this in turn would depend on how much demand was slowing, supply challenges were being resolved, and price pressures were easing.

Minutes from the March meeting of the Federal Open Market Committee (FOMC) of the Federal Reserve showed that the prevailing view of the Fed's economic research team was that the fallout of the banking crisis would ultimately lead the US into a mild recession later in the year with a recovery over the following two years. That said Committee members were confident that the benchmark inflation measure that the Fed uses to measure inflation would slow sharply in 2024. Several members wanted to hold rates steady because of the banking crisis but relented and rates at the March meeting were hiked 25 basis points to a range of 4.75% to 5.0%, with Committee members noting that inflation was "much too high".

The FOMC released a policy statement following the meeting of May 2 through May 3. The fed funds target range was lifted by 25 basis points to 5.0% to 5.25%. This marked the 10th rate hike in succession for a total of 500 basis points (bps) or 5.0%. Importantly the Fed dropped a portion of the March statement

to the effect that the Committee anticipated “that some additional policy firming may be appropriate” in order to attain a stance of monetary policy that was sufficiently restrictive to return inflation to 2 percent over time. Instead, the Committee merely stated that in determining the extent to which additional policy firming might be appropriate to return inflation to 2.0% over time, the Committee would take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.

This was a signal that the Fed could hold rates steady at its following policy meeting on June 13-14.

In the post policy statement-release press conference Fed Chair Powell stated that while inflation had moderated somewhat since the middle of last year, inflation pressures nonetheless continued to run high and the process of getting inflation back down to 2.0% “had a long way to go”. He restated the Fed’s strong commitment to returning inflation to the 2.0% objective and to keeping longer-term inflation expectations well anchored.

The Fed decision was criticised because it came in the middle of a regional banking crisis in the US and while adding almost nothing to the fight against inflation could easily have intensified the stresses from the crisis. On the day of the policy statement shares of US regional banks were crushed once again.

The “pause in rate hikes option” theme was soon taken up by members of the Committee. Voting member Neil Kashkari for example stated that if the Committee were to skip raising rates in June this would not mean that it was done with its tightening cycle. Any pause would be informed by incoming data including information concerning credit conditions. But “nobody should be confused about our commitment to getting inflation back down to 2.0%,” he added.

The minutes from the May meeting revealed a Committee divided over how much future policy tightening was called for. Some members assessed that progress in reducing inflation was “unacceptably slow” and would necessitate further hikes. “Several” FOMC members however saw slowing economic growth in which “further policy firming after this meeting may not be necessary.” It was unclear whether all or some of such further members were voting members of the Committee.

In an address soon after the release of the minutes, Fed Chair Powell stated that the regional banking crisis was contributing to tighter credit conditions that were likely to weigh on economic growth, hiring and inflation. Accordingly, “our policy rate may not need to rise as much as it would have otherwise to achieve our goals”.

At its policy meeting June 13-14, the FOMC unanimously decided to keep the fed funds rate target range unchanged at 5.0%-5.25%. The statement explained that holding the target range steady allowed the Committee to assess additional information and its implications for monetary policy.

In the press conference Powell explained that the Fed had already “significantly” tightened the stance of monetary policy. The FOMC had covered a lot of ground, and the full effects of policy tightening had yet to be felt because of the lag between policy decisions and actual changes in economic activity. Because of this and the potential headwinds from credit tightening due to the banking crisis, which were likely to weigh on economic activity, hiring, and inflation, the Committee had decided to stand pat on rates. However, looking ahead, nearly all Committee participants viewed it as likely that some further rate increases would be appropriate this year to bring inflation down to 2.0% over time. The pause could therefore be said to be “hawkish” Powell observed that the labour market had remained very tight despite the pace of rate hikes although there were some signs that supply and demand in the labour market were coming into better balance. Inflation was said to have moderated since the middle of last year but inflation pressures continued to “run high” and the process of getting inflation back down to 2.0% had a long way to go. The rate’s pause was in reality more of a rate’s skip.

The Summary of Economic Projections accompanying the policy statement was as usual extremely instructive. The median view for the trajectory of the fed funds rate by end 2023 was set at 5.6% from a previous 5.1%, implying two additional rate hikes this year. This was seen falling to 4.6% by end-2024 and 3.4% by end-2025 up from a prior 4.3% and 3.1%, respectively.

All this is to say that the FOMC saw the fed funds rate as going higher for longer and cuts to the target range were only being envisaged later in 2024. To put it another way a rate cut would only be appropriate should inflationary pressures ease really significantly.

After the decision the fed funds futures market was pricing in a 61.5% chance of a rate hike at the July 25-26 FOMC meeting. The DJIA ended the session 257 points (minus 0.7%) after being lower by over 400 points at one stage. The S&P500 was off 0.6% and the Nasdaq 0.7% at their session lows, but later recovered to end flat on the day. Stocks traded skittishly over the next four or so sessions.

Chair Powell reaffirmed the hawkish nature of the rate pause in his Semi-annual Congressional testimony on June 21 and 22.

2. The Debt Ceiling Debacle - Facing Relegation

The second quarter was dominated by a political struggle over raising the US debt ceiling. The debt ceiling represents the maximum amount the US government can borrow through the issuance of bonds. The debt ceiling was created by law in 1917. It currently stands at approximately US\$31.4 trillion or 117% of US GDP. When the debt ceiling is hit the Treasury must use emergency funding or other extraordinary temporary measures to make good on the country's spending obligations until the ceiling is lifted. The debt ceiling covers spending already authorised and does not authorise any new spending. Any debt ceiling bill requires a special majority of 60 Senate votes to avoid a filibuster because it is not an appropriations bill such as legislation associated with the passing of budget measures.

Political wrangling over the debt ceiling is nothing new. In 2011 there was a standoff between then President Obama and a Republican-controlled House of Representatives that sent shares plummeting and borrowing costs surging on fears that the US would default on its debt. At the time rating agency S&P Global cut its credit rating for the US to AA+ from AAA. In 2013 another debt ceiling impasse arose as it tends to do when Presidential and Congressional power is divided between Democrats and Republicans. But despite the debt crisis going to the wire, the US did not default on its debt then and has not at any stage in its history.

This time around the debate over the debt ceiling started in earnest in mid-April. Estimates at the time put the deadline for the lifting of the ceiling at beginning to mid-June. The debt ceiling struggle this time around played out against the backdrop of high inflation, rising interest rates, a regional banking crisis and fears of a recession.

A default on US debt would be calamitous, rendering the country unable to pay its creditors and ending payments for example to the military, to other federal government employees, for Medicare, Medicaid, Social Security and for tax refunds. In such circumstances credit rating agencies would downgrade the US' sovereign credit rating leading to a ramping up of the cost of borrowing. In reality it would be a catastrophe of global proportions.

On April 19 Treasury Secretary Janet Yellen warned of the dangers of leaving an agreement to raise the debt ceiling until the last minute and urged Congress to pass a bi-partisan bill as soon as possible. She set the deadline day for the passage of a bill at June 1, the so-called X-date.

On April 26 House Speaker Kevin McCarthy introduced a bill that tied raising the debt ceiling for a year to broad and sharp spending cuts. The bill passed in the House by 2 votes. But President Biden had already stipulated that he would not sign any debt ceiling bill if it came with spending conditions. He wanted a so-called clean raise and any discussion of spending cuts to take place as part of the budgetary process.

Janet Yellen weighed in again on May 7, stating that a failure to pass debt ceiling legislation by early June would cause a "steep economic downturn" in the US and that "financial and economic chaos" would ensue. She reiterated that the US government could begin to default on its financial obligation as early as June 1.

A report by rating agency Moody's predicted that were the US to default, GDP would drop 4% and 7 million workers would lose their jobs. Under such a scenario, stocks would come off between 20% and 25%.

On May 9 Congressional leaders met with President Biden but no deal was forthcoming. Markets at the time were not factoring in a sovereign default with investors believing a deal would be reached just in time as it had before and in any event the federal government could prioritize the payment of interest on bonds and bills, such that a technical default could be postponed. After all the debt ceiling has been raised over 100 times before so this was hardly an event without precedence.

On May 16 President Biden met again with House Speaker McCarthy and for the first time progress was said to have been made on the negotiations' framework although McCarthy viewed the parties as still far apart. President Biden on the other hand stated that a deal could be reached.

Still, US businesses were worried. Over 140 business leaders wrote an open letter to Congress warning of "disastrous consequences" if a debt ceiling deal was not reached in time.

By the 17th of May McCarthy came out and stated that he did not think the US would default on its debt saying he would make sure that a deal would be closed. President Biden echoed these sentiments.

But markets swooned after McCarthy said it was time to "press pause" on the negotiations. As it turned out bi-partisan talks resumed that very night. Yellen restated that June 1 was a hard deadline.

On May 22 McCarthy noted that negotiations had been professional and productive but still no agreement had been reached. The big question was whether the Speaker could overcome resistance from his party's extreme right wing and cut a deal. This was true too of President Biden who had the Democratic Party's left wing to contend with.

The clock was ticking and bond markets in particular were edgy. In truth equity markets never took the risk of a sovereign default that seriously but there were several down days attributable to the standoff.

On May 24 Fitch Ratings placed the US AAA default rating on negative watch. The agency said that while it still thought there would be a resolution to the crisis "the brinkmanship over the debt ceiling, (the) failure of the US authorities to meaningfully tackle medium-term fiscal challenges that will lead to rising budget deficits, and a growing debt burden, signal downside risks to US creditworthiness".

The IMF in a preliminary annual assessment of the US wrote that "brinkmanship over the federal debt ceiling could create a further, entirely avoidable systemic risk to both the US and the global economy".

Two days later Janet Yellen extended the default date until June 5, buying negotiators some additional time to strike a deal. Yellen explained that the Treasury would make more than US\$130 billion of scheduled payments on the first two days of June but that during the week of June 5 scheduled payments and transfers of US\$92 billion would not be able to be made.

Markets rallied late on May 26 when President Biden declared himself "very optimistic" about a debt ceiling deal.

The following day a tentative arrangement was announced between Biden and McCarthy to suspend the debt ceiling for two years rather than raise it by a stipulated amount. The agreement contained compromises on both sides. Democrats agreed to keep spending flat in its 2024 budget and increase it by only 1% in 2025 in exchange for a two-year deal on the debt ceiling. Over 10 years spending cuts would amount to US\$1.5 trillion. There were other agreed terms such as an easing of permitting for energy and mining projects.

On May 31 the House of Representatives passed the debt ceiling bill by a wide margin of 314 to 117. This was a much wider margin than expected. Markets cheered the legislation as well as the bi-partisan process of its coming into being. The Act thereafter moved to the Senate for consideration. On June 1 the vote was a resounding 63 to 36 in favour. Again, this was viewed as a victory for the bi-partisan centre of US politics. On June 3 President Biden signed the bill into law as the Fiscal Responsibility Act.

Moody's immediately made it known that it was not now considering a downgrade of the US default credit rating.

President Biden declared that "no one got everything they wanted but the American people got what they needed. We averted an economic crisis and an economic collapse".

That's all well and good. The debt ceiling crisis was ultimately averted but it was extremely troubling that it took until the very last minute to do so. Hopefully in two years' time the process will be more expeditious.

3. A Hawkish SARB - Tactical Ineptitude

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) met once during the quarter. On May 25, the MPC controversially raised the benchmark repurchase rate by 50 bps to 8.25%. The decision was unanimous. The rate hike followed a March raise of 50 bps and marked the high-point for the repo rate since 2009.

The Committee cited loadshedding and logistical constraints as principal impediments to the growth outlook. The MPC slightly raised its 2023 forecast for South Africa's GDP growth rate to 0.3%, and kept the forecast for 2024 and 2025 unchanged at 1.0% and 1.1% respectively. Loadshedding was seen subtracting a full 2.0% percent from annual growth. The prospects for future growth were characterised as "uncertain". The Bank's model was based on a projected 280 days of loadshedding in 2023, 150 days in 2024 and 100 days in 2025. Loadshedding was estimated as costing R0 to R1.2 million for stages 1 and 2 and up to R204 to R899 million for stages 3 to 6, when continued on a 24-hour basis on weekdays. The Committee noted that increased energy supply from other sources would greatly enhance growth. The MPC stated further that the risks to the medium-term domestic growth outlook to be balanced.

On inflation, the Committee was of the view that the weak rand had increased import price inflation. The implied starting point for the US dollar rand exchange rate was now R18.68 up from R17.80 at the March meeting. The rand was expected to remain volatile and sensitive to "idiosyncratic shocks". This was SARB-speak for loadshedding, political risks and the shocking state of South Africa's infrastructure.

Given upside inflation risks, larger domestic and external financing needs, and loadshedding, further currency weakness appeared likely. Domestic inflation had been on the rise due to fuel, energy and food price inflationary pressures. Fuel price inflation was seen coming off to minus 2.0% in 2023 while the electricity was also seen lower at 11.6% for 2023. Food price inflation was however projected to rise despite falling global food prices, because of rand weakness. The forecast for headline inflation for 2023 was revised up to 6.2% (from 6.0%). Headline inflation for 2024 was also increased to 5.1%, before a moderation to 4.5% in 2025 on the back of easing food and fuel inflation.

Risks to the inflation outlook were assessed to the upside. Global oil markets were expected to remain tight posing an upside risk to prices. Electricity prices and other administered prices continued to present clear short- and medium-term risks. Domestic food price inflation continued to be elevated, and additionally loadshedding could have "broader price effects on the cost of doing business and the cost of living".

Headline inflation was forecast to remain above the upper end of the inflation target range (6.0%) until the third quarter of 2023, and would only sustainably revert to the mid-point of the target range by the second quarter of 2025.

It was against this backdrop that the MPC decided on a 50 bps hike. The Committee said that at the current level of the repo rate, monetary policy could be described as "restrictive".

The MPC stated that monetary policy efficacy would be enhanced by reaching a prudent public debt level, increasing the supply of energy, moderating administered price inflation and keeping wage growth in line with productivity gains.

Because South African inflation is of the cost-push variety and not derived from demand, the MPC decisions are principally aimed at keeping the rand stronger so as to control imported inflation. But the latest rate hike had the opposite effect, frightening foreign investors and causing the rand to depreciate to R19.88 versus the greenback. It was a lesson in the futility of tightening monetary policy in small increments to protect the rand. Indeed, over the period of the current cycle of rate hikes the rand has depreciated 26%. Given the parlous state of the South African economy the Bank had every reason to pause this time around and not engage in fruitless policy tightening that served to place further pressure on consumers.

The other highlight or as the case may be the lowlight of the quarter was the intensification of a policy spat between South Africa and the United States over the war in Ukraine. South Africa had professed a stance of neutrality towards the war but in reality, statements issued by the Department of International Relations and Co-operation (DIRCO) revealed a pro-Russia bias. There has been a steadfast refusal for example to condemn the invasion. And just in February, South Africa held naval exercises with China and Russia. Matters came to a head when the US ambassador accused South Africa of supplying armaments to Russia while a Russian vessel subject to US sanctions docked at the naval base in Simonís Town in December. South Africa denied the charges. The ambassador later issued a half-hearted apology for his remarks and an independent panel was established to investigate the vessel's presence in South Africa.

The dispute threatened South Africa's position as a beneficiary of Agoa, the African Growth and Opportunity Act. The Act allows for tariff and quota free exports from South Africa to the US provided US producers have met their production quotas. The Act has been in existence since the Clinton presidency and has been renewed several times. It is up for renewal again in 2025. South Africa is lucky to benefit. The Act predominantly benefits low-income African countries and South Africa is a middle-income country.

Agoa is extremely important for the South African export sector. According to US government statistics in 2021 for example, South Africa exported US\$206.05 billion's worth of goods to the US and ran a trade surplus of US\$191 billion. Total SA exports under Agoa in 2021 amounted to US\$39.5 billion or 13.36% of all exports to the US. In 2022 SA's exports to the US came to US\$275 billion and South Africa ran a trade surplus of US\$151 billion in that year. Exports to the US under Agoa totalled US\$59.59 billion or 21.66% of total exports to the United States. The export of vehicles amounted to just over US\$30 billion alone. The loss of US\$60 billion per year together with the jobs that produce these exported goods is simply unthinkable.

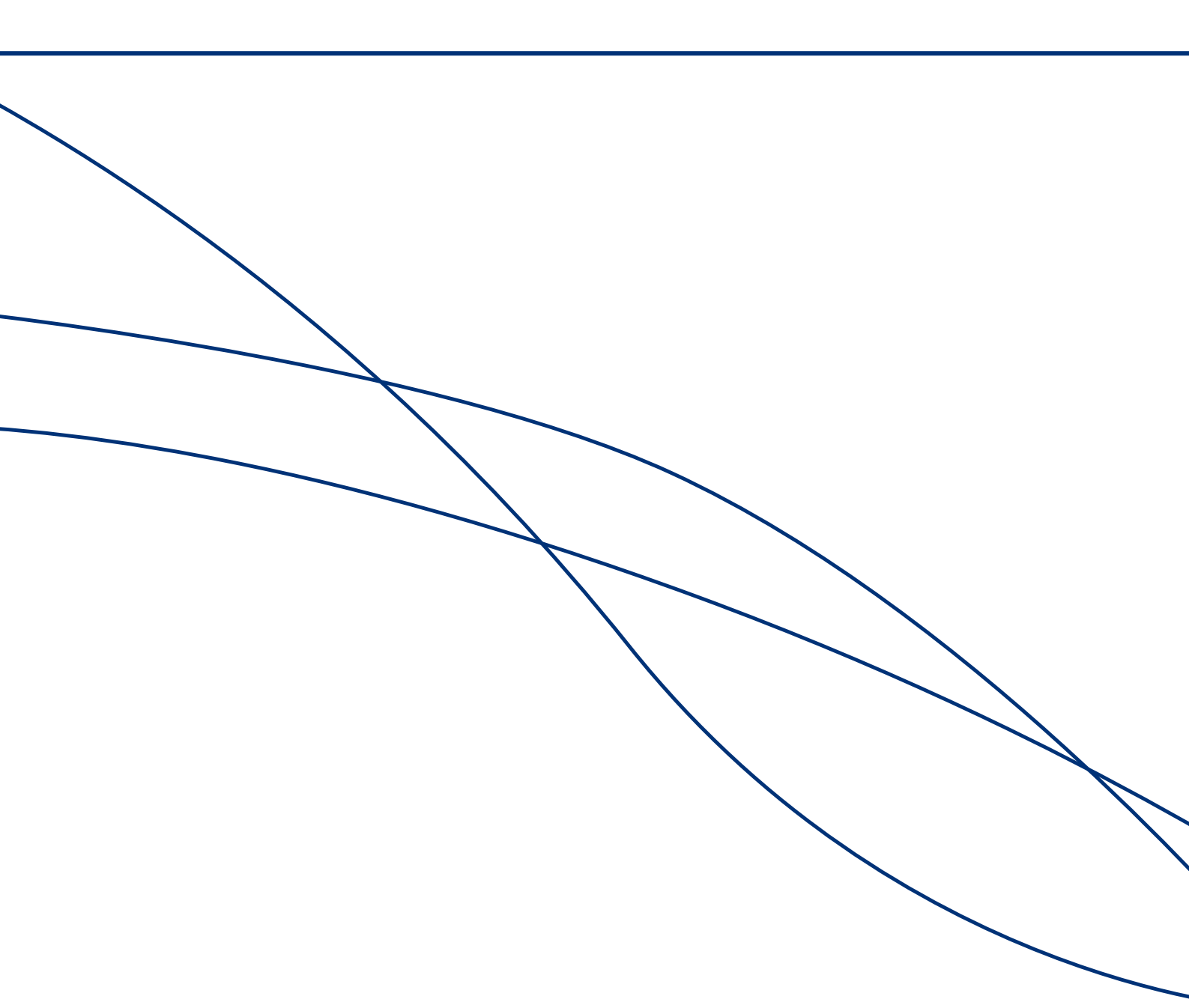
But Agoa's beneficiaries can lose their privileged status under Agoa by reason of human rights abuses, supporting terrorism, for raising unacceptable barriers to US trade and for acting contrary to the United States' national security or foreign policy interests.

It was the possible contravention of this latter stipulation that sent markets into a tailspin.

The South African rand reached an all-time low against the US dollar and SA bond yields surged as foreign investors headed for the exits. Foreign ownership of local bonds has dropped to 26% from 43% a few years back. The FTSE JSE All Share Index fell around 4% in the ensuing days. The government was forced to take action to calm markets and sent a delegation to Washington led by Sydney Mufamadi, the President's legal advisor and the deputy-Minister of DIRCO to speak to their American counterparts and members of Congress to discuss inter alia South Africa's participation in Agoa and the Agoa Summit due to be held in South Africa in the second half of the year.

South Africa faces another quandary. It is due to host the BRICS Summit in late August to which Russian President Putin has been invited. But Putin is subject to an arrest warrant issued by the International Criminal Court for the prosecution of the war in Ukraine, specifically the abduction of Ukrainian children and their repatriation to Russia. It will be interesting to see how the government gets around that problem.

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



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