

THE QUART 40IFO

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

Quarter Three 2023 in Review

Introduction

Welcome to the Q3 2023 edition of The Quart.

We find ourselves in early Q4 2023 and how different the world looks from just the end of Q3, 2023, a few weeks ago.

October 7 saw the Middle East erupt into unprecedented violence and savagery with an attack by the Hamas terror organization on Israeli civilian communities and a well-attended music festival in the south of the country. In addition to over 1,400 murdered Israelis, over 200 men, woman and children of all ages were taken hostage as well. Stunningly, notwithstanding the 50-year anniversary of the Yom Kippur War, the Simchat Torah festival (marking the receiving of the Torah) and the Sabbath, the Israeli intelligence community and the IDF dropped their guard. All this just as in the background the Israelis and Saudis were inching towards cementing a peace deal that could have transformed the entire region for the better.

[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).

A heavy price was paid and now we watch as world powers try to mediate the situation and efforts are made to recover the hostages. Nothing quite galvanises the world media and world opinion as a flare up in the Middle East. Whereas the focus of the world media was fairly and squarely on the Russia/Ukraine war, that ongoing event receives little to no attention now. Mr. Putin must be satisfied with this situation.

We hope and pray for a speedy return of the hostages and an end to hostilities that will translate into a long-term arrangement that will improve the lives of peace-loving Israelis and Palestinians alike.

As far as the markets are concerned, nothing much to write home about over the quarter. It was a torrid time for equities and bonds because of the Fed's interest rate policy stance. I will leave it to The Judge to explain the detail.

The Judge also takes us through:

- a very interesting analysis of what is happening in the Chinese economy – is the growth engine of the world over the past few decades running out of steam?
- SA environment – some slightly more encouraging economic news in line with less loadshedding of late – are we just burning more diesel?
- On a more positive note – The Bokke won an unprecedented fourth World Cup on the weekend and The Proteas are doing us proud – bring it home!

We hope you enjoy the read.

Kind 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.

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The Quart is in Session

Market Activity – Weakness on the Bok of Fed Hawkishness

Major US indices had a poor September, historically the worst of months for US stocks. The Dow Jones Industrial Average (DJIA) ended the final week of the quarter lower by 2.2% the worst weekly performance since March. For September the DJIA was down 3.5% and for the third quarter gave up 2.6%. On a year-to-date (YTD) basis the DJIA has managed to cling to a gain of 1.09%.

The S&P500 ended September with three consecutive down weeks, with a final week's performance of minus 2.11%. For the month of September, the index surrendered 4.9%, its worst month of the year, and for Q3 2023 the index was off 3.7%. Still YTD, the S&P is 11.68% to the good helped by gains in its large cap tech constituents.

The Nasdaq Composite (Nasdaq) also ended the month with three consecutive down weeks for the first time since last December. For September the Nasdaq lost 5.8%. This also represented the worst monthly performance of the year. For the quarter the index was off 4.1%. But for the year the Nasdaq is still higher by 26.30%. Gains have been concentrated among large cap tech stocks like NVIDIA, Meta Platforms, Tesla and Amazon.

Weakness in September's stock performance can be attributed to:

- Hawkish outcomes of the Fed's September meeting and uncertainty regarding the Fed's policy outlook;
- Ongoing geo-political risk centred on, but not limited to, the war in Ukraine;
- A spike in the price of crude oil;
- A more restrained outlook for the Chinese economy;
- The prospect of a partial federal government shutdown in the US absent a last-minute deal to pass spending legislation; and
- Historical factors playing into a typically weak September.

In Europe the German DAX30 was better off by 10.51% YTD, while the French CAC40 improved 10.33%. The EuroStoxx50 rose 10%. The FTSE100 by contrast was only higher by 0.71% in that time.

Amongst emerging markets YTD Brazil's Bovespa climbed 9.6%, the Hang Seng was down 11.59%, the Shanghai Composite flat and the MSCI Emerging Market Index which is denominated in US dollars was 0.38% worse off.

Locally the FTSE/JSE AllShare Index (Alsi) lost 0.91% YTD and the FTSE/ JSE Top 40 Tradeable Index (Top 40) gave up 0.68%. The rand has fallen 11.36% against the US dollar YTD, so that local indices are a lot worse off in US dollar terms.

YTD crude oil has risen 13.08% but gold has shown a more muted gain of 1.4%.

Quarterly Themes

1. Hit or Miss: Aim at the Poles

The minutes of the meeting of the Federal Open Market Committee (FOMC) of the Federal Reserve were released in early July. The minutes revealed that many meeting participants noted that after rapidly tightening the stance of monetary policy "the Committee had slowed the pace of tightening

and that a further moderation in the pace of policy firming was appropriate" in order to afford the Committee time to observe the effects of policy tightening and their implications for monetary policy. After the release of the minutes the fed funds futures market was pricing in an 89% chance of a rate hike at the July meeting.

The biggest concern for the market was possible policy overreach of the Fed which could lead to a sharp recession in the US and by inference globally. Voting member of the FOMC, Austan Goolsbee addressed this issue on July 7, noting that the Fed could control inflation without causing a recession. He said the Fed was on a "golden path" where even a few future rate hikes amid an "outstanding" jobs market would not bring about recessionary conditions.

At its policy meeting July 25-26, the FOMC hiked the fed funds target range by 25 basis points to a range of 5.25% to 5.5%, the highest level in 22 years. It was the 11th rate increase in 12 meetings. At the June meeting the Fed had kept the target range for the benchmark rate unchanged. The monetary policy stance was now officially restrictive.

At his post-meeting press conference Chairperson Powell reiterated the Fed's "strong commitment" to bringing inflation down to its 2.0% objective. Powell observed that consumer spending appeared to have slowed from earlier in the year, and that higher interest rates and slower output growth had negatively impacted business fixed investment. In the interest rate sensitive sector of housing, activity was well down on a year ago. But the labour market remained very tight despite job growth over the past three months having slowed from the pace seen earlier in the year. Inflation continued to run at a rate "well above" the longer run goal of 2.0% although it had "moderated somewhat". The process of getting inflation back down to 2.0% "had a long way to go". In the process the US would experience below-trend growth and a further softening of the labour market.

Equity markets had factored in the rate hike and the DJIA extended its winning streak to 13 consecutive days of gains after the rate announcement. The fed funds futures market was now factoring in just a 20% chance of a rate hike at the September policy meeting.

But some Fed officials were warning that the tightening cycle was not necessarily over. FOMC voting member Michelle Bowman stated that if progress on taming inflation stalled the Fed should not hesitate to raise the target rate further. In other words, it was premature to categorically state that further rate hikes were off the table. "I'm not ready to say that we're done", said FOMC voting member Neel Kashkari.

Fellow voting member Patrick Harker took the opposite view, stating that the Fed was at the point where it could be patient and hold rates steady and let the monetary policy actions taken by it do their work.

This policy tension was evident in the minutes of the July meeting. Two FOMC members favoured holding rates steady in July while several FOMC members saw "significant" upside risks to inflation which could necessitate further tightening.

At the central bankers' symposium in Jackson Hole August 25th, Chairperson Powell said that while it was encouraging that inflation had moved lower from its peak, it remained "too high". The Fed was prepared to raise rates further if appropriate and intended to hold monetary policy at a restrictive level until confident that inflation was moving sustainably lower towards the Fed's objective.

The FOMC met again on September 19-20. The Committee as expected kept the target range for the fed funds rate unchanged at 5.25% to 5.50%. In the policy statement the FOMC upped its assessment of US economic activity stating that it has been expanding at a "solid" pace. Job gains had slowed in recent months, but had remained "strong" and the unemployment rate had stayed low. Inflation meanwhile remained "elevated".

In the accompanying Summary of Economic Projections, the median view of FOMC members for 2023 GDP was 2.1% compared to just 1.0% at the June meeting. The median view of the unemployment rate for 2023 was lowered to 3.8% for 2023 from a prior 4.1%. The median view of the Fed's preferred inflation benchmark was taken down to 3.7% from 3.9%, only getting to the 2% objective by 2026.

Most importantly the median view for the projected trajectory of the fed funds rate for 2023 was set at 5.625%, implying another rate hike this year. For end-2024 the fed funds rate was seen at 5.125% implying two rate cuts in that year, but a level much higher than estimated in June where the rate was seen at 4.625% at end-2024.

In this sense the policy outcomes of the meeting were pretty hawkish.

In his press conference, Powell reiterated that the Committee had covered a lot of policy ground already and the full effect of all that tightening had yet to be felt. But while much had been done, the process of getting inflation sustainably down to 2.0% had “a long way to go”. The FOMC was prepared to raise rates further if appropriate and in any event the Committee would hold rates at a restrictive level until it was confident that inflation was moving sustainably down to the 2.0% objective.

Stocks were down on the day with the DJIA lower by 0.22%, the S&P500 off 0.94% and the Nasdaq Composite down a full 1.53%, all contributing to a dismal September for US stocks. Bond were sold off viciously with yields ramping up on the Fed news. The yield on the 10-year Treasury hit 4.498% its highest level since 2007 and the yield on the 2-year got to 5.2% its highest level since 2006.

Matters were exacerbated by hawkish signalling from FOMC voting members. Michelle Bowman stated on September 22 that raising rates further in the current circumstances would be appropriate and Neel Kashkari who warned that rates might have to go “meaningfully higher” in order to tame inflation.

2. US Budget Blues - Bringing on the Bomb Squad

Late in the quarter market attention was drawn to the possibility that Congress might not pass a spending bill (essentially budget legislation) by the requisite deadline of 00h01 on Sunday October 1, the commencement of the Federal government fiscal year.

The upshot of not passing the bill would be a halt to government funding, a partial closure of the federal government and the inability of the Federal government to undertake discretionary spending. Two-thirds of federal funding is mandatory and would not be affected. But a third of spending requires annual authorisation.

The situation is unlike the debt ceiling crisis that the US experienced last quarter. That crisis was centred on the power of the federal government to borrow in order to meet financial obligations already incurred and threatened to halt payment to bondholders.

The Republican party which controls the House of Representatives where spending bills originate, was divided on the matter with House Speaker Kevin McCarthy favouring a 45-day stopgap spending bill which would kick the can down the road to November. This is typically how politicians resolve crises around spending authorisation. But members of the extreme right faction of the Republican party demanded US\$120 billion in spending cuts including cuts to Social Security and Medicare and were implacably opposed to a stopgap measure, meaning that any such measure would have to be a bi-partisan affair with Republicans and Democrats voting together to support it.

The last federal government shutdown occurred in 2018 and lasted 35 days. Prolonged shutdowns are negative for US growth and stocks, with the S&P500 seen likely to fall around 10% in such an eventuality. That certainly was the experience in the 1980's and 1990's when government shutdowns were quite common events. There have been four federal government shutdowns in the last decade but they have tended to last longer. The longer they last the greater the market dislocation.

Were a shutdown to occur, the jobs of around 2 million US service members and 1.5 million federal civilian employees would be in jeopardy. As in 2018, a number would be furloughed and entitled to back pay when the crisis was resolved. Even statistical agencies like the Bureau of Labour Statistics and the Bureau of Economic Research would be shuttered, meaning that key data prints like the non-farm payrolls report and the CPI print do not get published. This would create enormous economic uncertainty. A shutdown would also lead to the furloughing of employees at the SEC meaning that filings relating to initial public offerings and mergers and acquisitions would not get reviewed.

As it turned out both the House of Representatives and then the Senate on Saturday September 30 passed a short-term funding bill which notably omitted funding to Ukraine. Congress has already approved around US\$113 billion in aid to Ukraine since the Russian invasion and President Biden has requested another US\$24 billion.

Voting was bi-partisan. In the House the stopgap bill passed by 335 votes to 91 and in the Senate the bill passed by 88 to 9. President Biden signed the bill into law late Saturday just ahead of the deadline.

The passage of the bill was both a victory for House Speaker McCarthy and a probable defeat for him as well.

There is little doubt that the hardliners in the House will try to get him removed from power. That is the price one pays in Washington for daring to rely on Democratic Party votes to pass a bill, even one as urgent as the current spending bill. In any event the whole saga will be repeated again in mid-November and absent McCarthy it is difficult to see a bi-partisan solution to the funding problem.

3. China's Economic Prognosis - No Four Try Bonus Point

The Chinese economy is losing momentum. Chinese GDP grew 6.3% year-on-year in Q2 2023 missing expectations for expansion of 7.3%. On a quarter-on-quarter basis GDP growth came in at 0.8%, above expectations for a rate of 0.5%, but well below the 2.2% quarterly rise in the prior quarter.

In September Moody's cut China's growth forecast for 2024 to 4.0% from 4.5% and left its 2023 forecast unchanged at 5.0%.

Back in March the Chinese government set a goal of around 5% for annual GDP growth, so this objective can still be met because it is much lower than the norm. But expectations for a prolonged recovery post-Covid due to pent up demand being released has proved elusive.

Quarter two real estate investment was down a substantial 7.9% in the first half of the year. The downtrend continued in August. The property sector once accounted for 20% to 25% of Chinese GDP.

The manufacturing Purchasing Managers' Index slipped below 50 for four straight months through July, signifying sector contraction, although it got above 50 in August. Imports and exports increased only 2.1% year-on-year. In the year to end-August trade volumes with the US, its biggest single country trading partner fell 15.4%. In July total exports fell a massive 14.5% on year and in August they were lower by 8.8%.

In March China stopped publishing monthly consumer confidence data after over a year of sub-optimistic readings.

China's GDP deflator, a broad measure of the price of goods and services, fell by 1.4% in the second quarter. In August Chinese year-on-year CPI stood at 0.1%. There are fears that China is facing a deflationary spiral such as that experienced by Japan.

All the talk is of a China that has already peaked, and a structural downtrend going forward.

And it is true. China's economy faces a raft of problems. The housing sector is contracting. There is an enormous housing inventory overhang in China's lower tier cities. House prices have begun to fall in many locales. Data show that households are taking out fewer mortgages. In September Moody's downgraded its outlook for the sector to "negative" from "stable". It sees home sales falling 5% over the upcoming 6-month to 1-year period.

Chinese property developers are highly indebted and some listed developers have run into trouble. In early August one of China's leading property developers, Country Garden, missed US\$22.5 million

in coupon payments on its dollar bonds and teetered on the brink of default. It later paid the amount just hours before the expiration of the 30-day grace period. Shares of Chinese developers rose sharply on the news. Sino-Ocean is another developer that ran into trouble repaying its debt. Evergrande, once the leading property developer in China defaulted in 2021. It recently filed for bankruptcy protection in the US. Evergrande has US\$300 billion in liabilities and its Chairman was recently placed under police watch. Trading in the stock has been halted.

Chinese youth unemployment stands at 20.8% four times the rate in urban areas. This is partly the legacy of Covid but the slumping housing sector has played a role as well. China has since stopped supplying youth unemployment data completely.

China is in the midst of transitioning the driver of its economy from the old economy export sector to domestic consumption. But Chinese consumers are inveterate savers due to the absence of a social safety net and the one child policy meaning the Chinese cannot rely on children to support them on their retirement. Instead of the post-Covid unlocking of pent-up demand, Chinese consumers have acted with caution given the property sector crisis and high youth unemployment.

The post-Covid period has resulted in a decoupling of western countries from China (Western countries talk of “de-risking”) amid widespread supply chain diversification and growing security concerns. Consumers in the West are struggling too as rate hikes and high inflation crimp borrowing and consumption. Chinese exports to the US and western Europe have fallen considerably as a result. China is now undertaking more trade with ASEAN (Association of South-east Asian Nations) countries than it is with the US or the EU. China’s share of US imports has fallen heavily from around 22% five years ago to close to 15% today.

Corporate borrowing has reached unsustainable levels. Total corporate debt now stands at 154% of GDP well up on the year. Government debt is not as much a concern given China’s propensity for running large trade surpluses and Chinese foreign currency reserves amounting to over US\$3 trillion. Household debt is minimal.

President Xi is averse to bailing out the economy with massive stimulus. China will have to grow via productivity gains and domestic consumer demand. The authorities have promised to come up with a plan to restore and expand consumption. What we have seen to date is limited support for the property sector in the shape of some debt relief and for the export sector where subsidies for locally produced goods have been broadened. The tourism sector has also been a recipient of stimulus measures. Chinese companies dominate the electric vehicle supply chain thanks to subsidies. The People’s Bank of China has cut rates as well and reduced banks’ reserve requirement ratios.

But as mentioned Chinese consumers are still preferring to pay down debt via their savings rather than spending on new items.

The Chinese Communist Party is asserting more control over local corporates pressurising them to house Communist Party Committees and making life for foreign corporates very uncomfortable as tensions between China and the West escalate. Many Western companies are leaving China and moving their production bases elsewhere. The old globalisation model simply does not hold anymore.

In October last year the US announced rules cutting off exports of high-end chips and semiconductor tools to China. In July China banned the export of chipmaking metals and their compounds. The world’s largest chip foundry, Taiwan’s TSMC cut off all exports of chips to China in 2020. China is banking on its chip manufacturing giant Semiconductor Manufacturing International Corp to make up the shortfall. More recently President Biden signed an order aimed at restricting US investments into Chinese semiconductors, quantum computing and artificial intelligence companies over national security concerns.

China hawks in Washington want to go further and scrutinize US asset managers’, private equity and venture capital firms’ investments in Chinese companies.

Having said all this, in my view it is far too early to write off China and its economic model as a spent force. As the Eurasia Group head Ian Bremmer has stated Chinese growth will continue to outpace that of the US. He argues that the “peak China” thesis is misguided and ideologically loaded. The US corporate sector is still overwhelmingly dependent on the Chinese market for growth and manufacturing capacity.

4. South African Outlook - A Committee Divided: André Pollard or Manie Libbok?

On 20 July the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) hit the pause button keeping the benchmark repurchase rate at 8.25%. The Committee was split with two members voting for a 25 basis points (bps) hike and three voting to keep rates unchanged. The Committee noted that at this level of the repo rate, monetary policy was restrictive, a stance consistent with elevated inflation expectations and serious upside risks to the inflation outlook. The Committee called on the public sector to take steps to lower inflation including achieving a prudent public debt level, increasing the supply of energy, moderating administered price inflation and keeping wage growth in line with productivity gains.

On 21 September the MPC released its second policy statement of the quarter. Again, the Committee was divided with two members opting for a 25 bps hike and three members preferring to keep rates on hold.

The SARB upped its South African GDP growth rate forecast for 2023 to 0.7% from the July figure of 0.4%. The growth rate forecasts for 2024 and 2025 were kept at 1.0% and 1.1%, respectively. The Bank said that South African households and businesses had proved resilient. An improvement in logistics and a sustained reduction in load-shedding, or greater energy supply from alternative sources, would significantly increase growth. At present, the Committee assessed the risks to the medium-term domestic growth outlook to be balanced.

On inflation, the Committee noted that the trajectory of CPI was influenced predominantly by fuel and food inflation. The Bank raised its fuel price inflation outlook to 0.4% in 2023 from minus 3.1% rising to 5.8% in 2024. Food price inflation was seen largely unchanged at 10.4% for 2023 and 5.2% for 2024. Because services inflation was seen lower in the near term, the Bank revised down average inflation for 2023 to 5.9% from 6.0%, just inside the target range of 3.0% to 6.0%. The headline inflation forecast for 2024 was increased slightly to 5.1%, before inflation was seen stabilising at 4.5% in 2025. Risks to the inflation outlook were assessed to the upside. In the absence of sustained increases in energy supply, electricity prices continued to present clear inflation risks, while load-shedding and logistics constraints could also have broader effects on the cost of doing business and the cost of living.

The Bureau for Economic Research survey revealed that inflation expectations across households and businesses remained elevated although they had come down marginally to 6.1%. The SARB wanted expectations anchored in the middle of the target range closer to 3%.

It was against this backdrop that a divided MPC kept the repurchase rate at 8.25%. At the current repurchase rate level, policy was restrictive, consistent with the inflation outlook and elevated inflation expectations. Serious upside risks to the inflation outlook were said to remain. In light of these risks, the Committee remained vigilant and stood ready to act should risks begin to materialise.

On 5 September Stats SA released South Africa's Q2 2023 GDP report. The domestic economy was said to have grown at a surprising rate of 0.6% quarter on quarter annualised after a 0.4% pick-up in Q1 2023. Expansion in the agricultural, manufacturing and financial sectors drove overall growth. Mining posted its second consecutive quarter of growth as well. Activity in transport and construction contracted. On the demand side growth was helped by a sharp rise in investment in machinery and equipment, including products related to renewable energy. This had the effect of increasing imports by 3.3% on the quarter. South African exports rose 0.9% on the quarter. Despite a decline in household consumption consumers continued to spend more on restaurants and hotels, a seventh consecutive quarter of growth for this category.

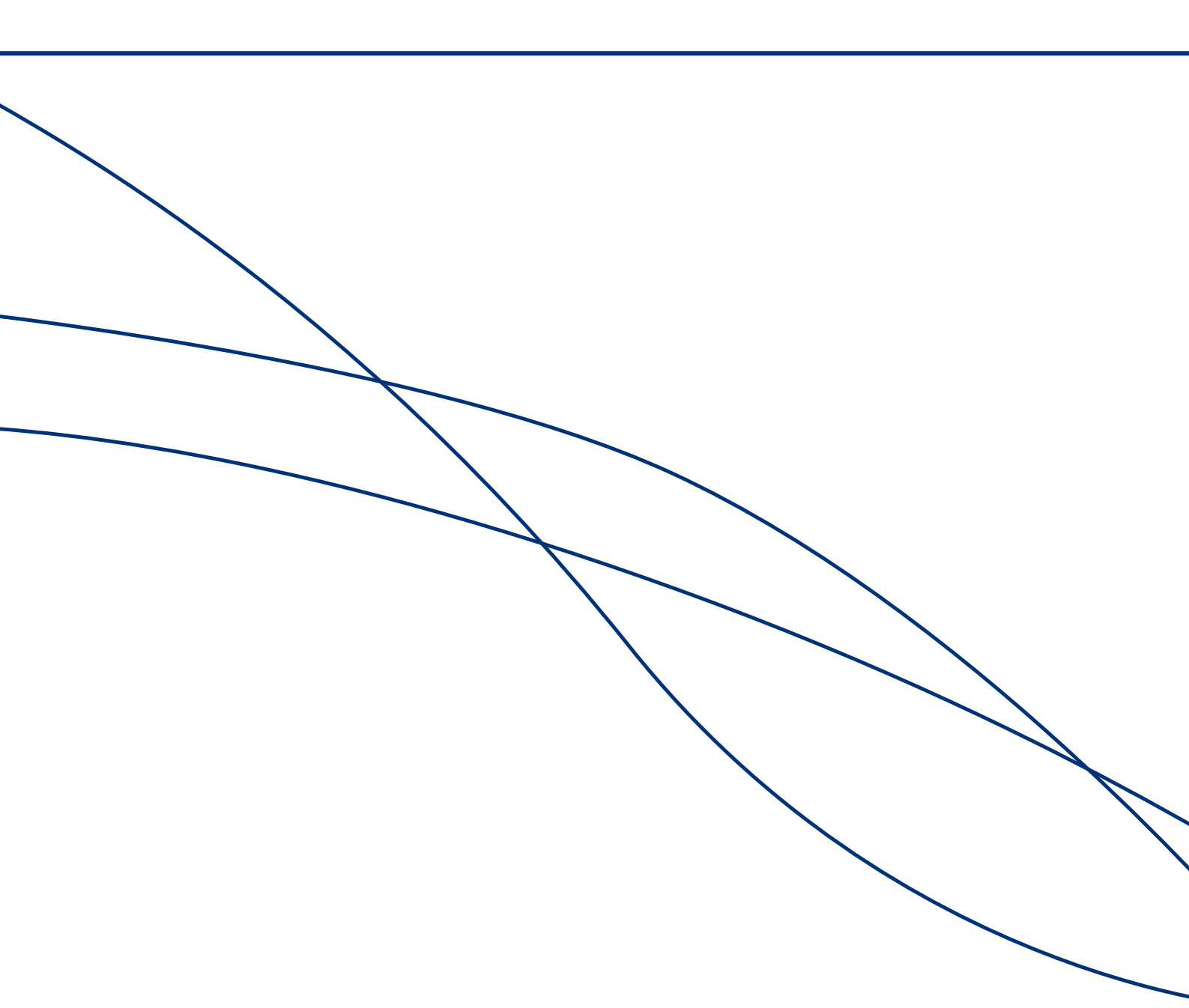
In late August South Africa hosted the 15th BRICS Summit. The major outcome of the Summit was the addition of six new countries as full members (Argentina, Egypt, Ethiopia, Iran, Saudi Arabia and the United Arab Emirates) to take the number of countries in the bloc to 11. The six countries will become formal members on January 1 2024. In so doing it was hoped by the existing BRICS members that the bloc would gain greater clout and have a better chance of rebalancing the current global political and economic order in favour of the “Global South”. After admission the BRICS bloc would constitute 37% of global GDP and 46% of the world’s population.

The BRICS Summit was seen as predominantly a victory for China’s ambitions. It is the formation’s largest economy and is the major trading partner of all the BRICS members who in reality trade little between themselves. By including oil exporters into the bloc China would have the opportunity to pay for crude in its own currency, the yuan, thus lessening the dollarisation of the global economic order, a major goal of the BRICS bloc. Plans to introduce a central bank and a single currency at this stage are more than a little premature. The BRICS’ New Development Bank has US\$100 billion in assets and has funded projects from a high-speed railway in India to a water management project in South Africa. It has a contingency reserve arrangement which is a short-term loan facility which can be tapped by members which run into trouble with their balance of payments.

From a South African perspective, BRICS’ membership benefits have proved elusive.

Since joining in 2010 South Africa’s economy has shrunk and GDP per capita, a proxy for living standards, has fallen from US\$8737 to a current US\$6795. The proportion of public debt to GDP meanwhile has ballooned from 31.2% to 72.3%. While membership has given South Africa a greater role on the international stage, rand and cents paybacks have been non-existent.

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



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OSRIN GROUP

20th 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**

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