BRENTHURST

THE HOME OF WEALTH

THE POWER OF INDEPENDENT ADVICE

IN THIS ISSUE

Inflation is one of the biggest risks to investments and savings.

It is a tax on the poor and often on investors as well.

FOR MORE INFO CONTACT US
www.brenthurstwealth.co.za

BRENTHURST RANKED TOP BOUTIQUE WEALTH MANAGER IN SA 2020 INTELLIDEX PRIVATE BANK AND WEALTH MANAGER AWARD

JHB (HQ)	+27 (0) 11 799 8100
JHB (SANDTON)	+27 (0) 10 035 1391
PTA	+27 (0) 12 347 8240
CAPE TOWN	+27 (0) 21 418 1236
BELLVILLE	+27 (0) 21 914 9646
CLAREMONT	+27 (0) 21 418 1236
STELLENBOSCH	+27 (0) 21 882 8706
PAARL (VAL DE VIE)	+27 (0) 21 100 3901
MAURITIUS	+ 230 5843 5215

ALL THE TALK ABOUT INFLATION - IS THERE A NEED TO BE WORRIED?

By Mike Schüssler, Brenthurst Wealth Consulting Economist

Globally markets are feeling increasingly jittery about the prospect of higher inflation. In the recovery phase, following the worst of the Covid-19 economic fall-out, commodity prices started rising significantly, exacerbated by an extremely low base created by unprecedented price declines when the bigger part of the global economy was in some form of economic lockdown.

For example, end of April last year, the Brent oil price was trading at $20/bbl, with the US WTI price at one stage tumbling into negative territory, as lack of demand and storage resulted in buyers paying suppliers not to take delivery of the oil. So now about one year later, the Brent oil price has touched $70/bbl (18 May), following an impressive recovery, partly driven by higher demand (as economies lift restrictions and demand started recovering) and also lower supply, as OPEC+ played a notable role in restricting oil supplies on the market. Similar trends played out in most other commodities, as reflected in The Economist All Items Commodities index **(graph 1).**

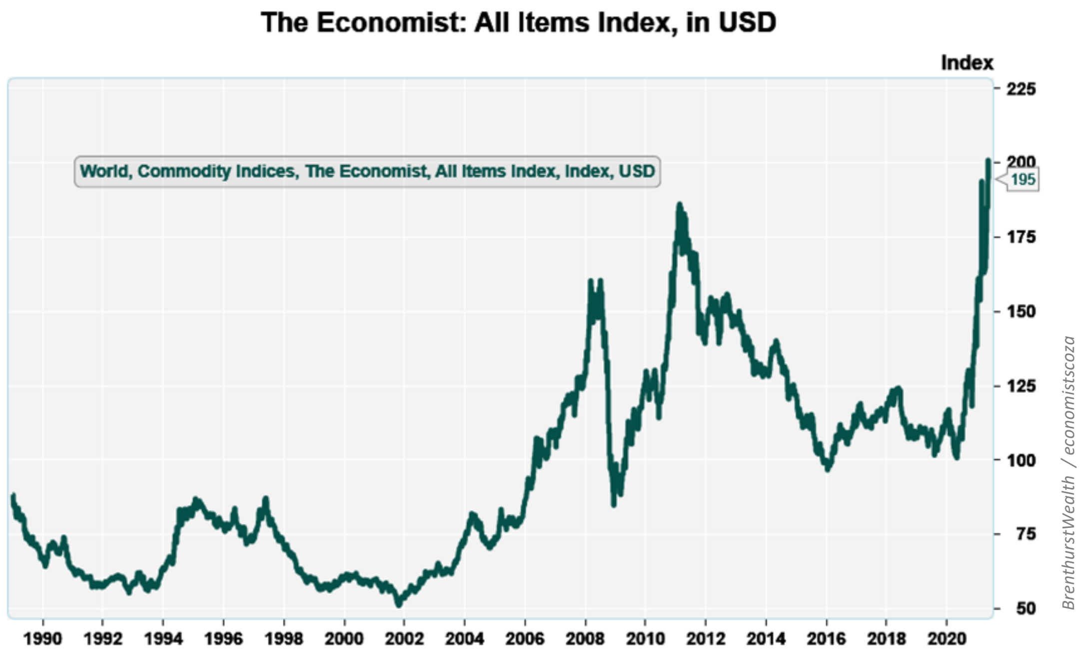
Graph 2 reflects the monthly change year on year in a selected subset of main commodity indices, all reflecting a similar trend. Food and metal prices play an important part in the outlook for inflation and food prices have increased at their fastest level in a decade but from a low base. Metal prices have increased at their fastest rate in decades. Again, from a lowish base. This is also why China in recent weeks warned that they will curb run away iron ore and steel prices. (China manufactures near 60% of the world's steel).

JUST A WORD OF CAUTION ON INTERPRETING ANNUAL COMPARISONS

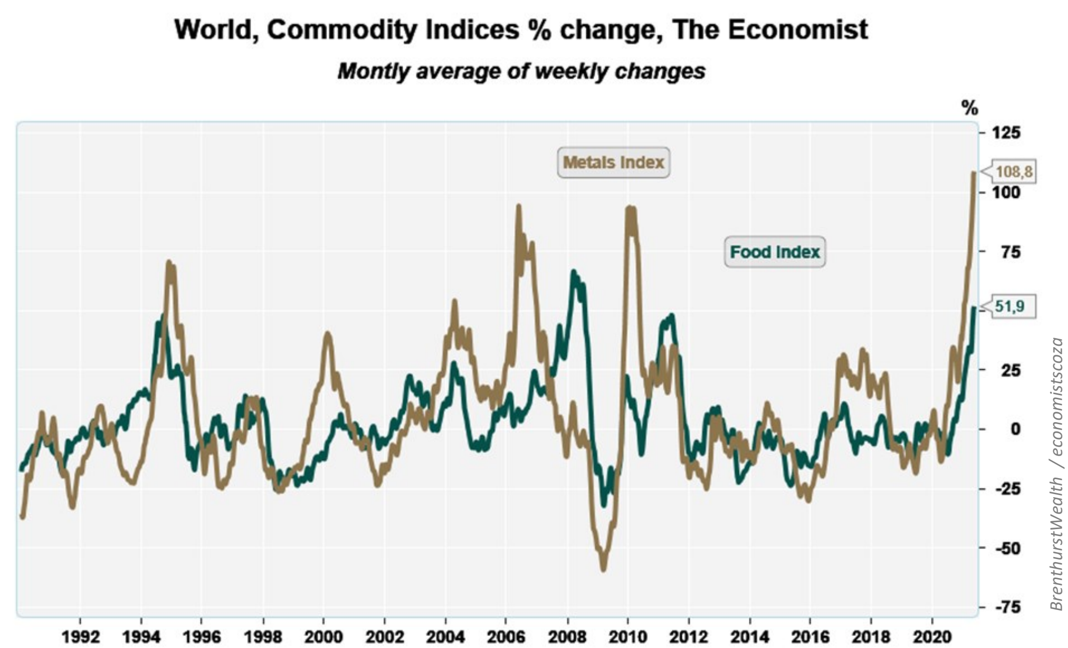
The global lockdown was most severe in April/May 2020, so the current annual comparisons are reflecting the change from that very low level one year earlier (price & production levels).

Growth rates should soon start to level off as global economies gradually opened in the subsequent months and the low base effect subsides. Thus, the spike in commodity prices is partly reflecting a low base, but also in some instances, the sectors' specific supply and demand factors. For example, the World Platinum Investment Council recently said that the global market for platinum will be in deficit for the third consecutive year as a bounce in supplies after a heavily disrupted 2020 is overtaken again by demand, pushing prices higher.

Graph 1:
The Economist magazine all commodity price index; scaling new highs



Graph 2:
Food and metal prices increasing fast but from a low base



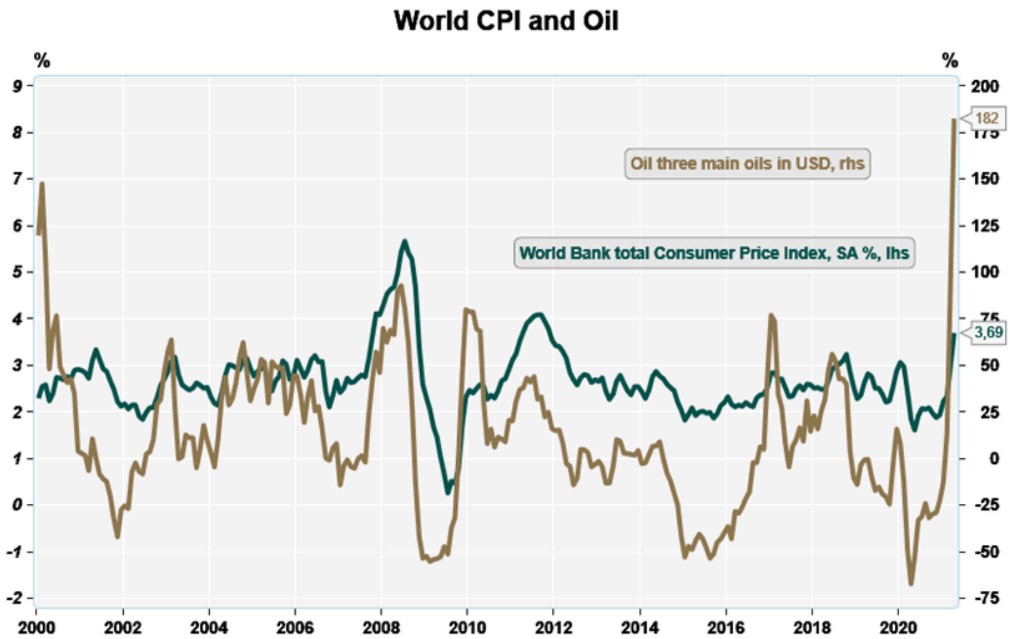
ZOOMING INTO THE LATEST TRENDS IN GLOBAL CONSUMER INFLATION

There are several factors that are currently driving consumer prices higher, a global phenomenon.

⇒ Higher commodity prices, specifically the price of oil, that filters through to higher fuel costs, have pushed world headline inflation rates higher.

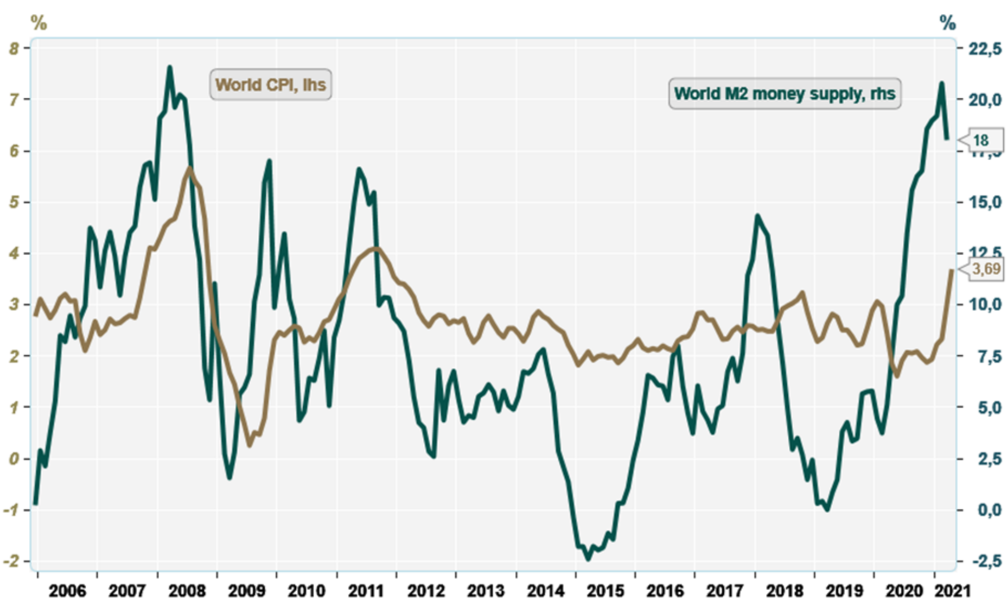
⇒ Recovery in demand, especially in countries where cash handouts to the whole population formed part of the Economic Recovery Stimulus Programs such as the US's multi-trillion fiscal aid package.

Graph 3:
World Consumer prices and oil prices



BrenthurstWealth / economistscoza

Graph 4:
World CPI vs World M2 money supply growth (y/y)



BrenthurstWealth / economistscoza

- ⇒ Recovery in employment levels, as economic activity picks up as restrictions are lifted.
- ⇒ The shortage of needed inputs for example the shortage of microchips, that has resulted in a price spike, which will in all probability be given through in the form of higher selling prices of the final manufactured items.

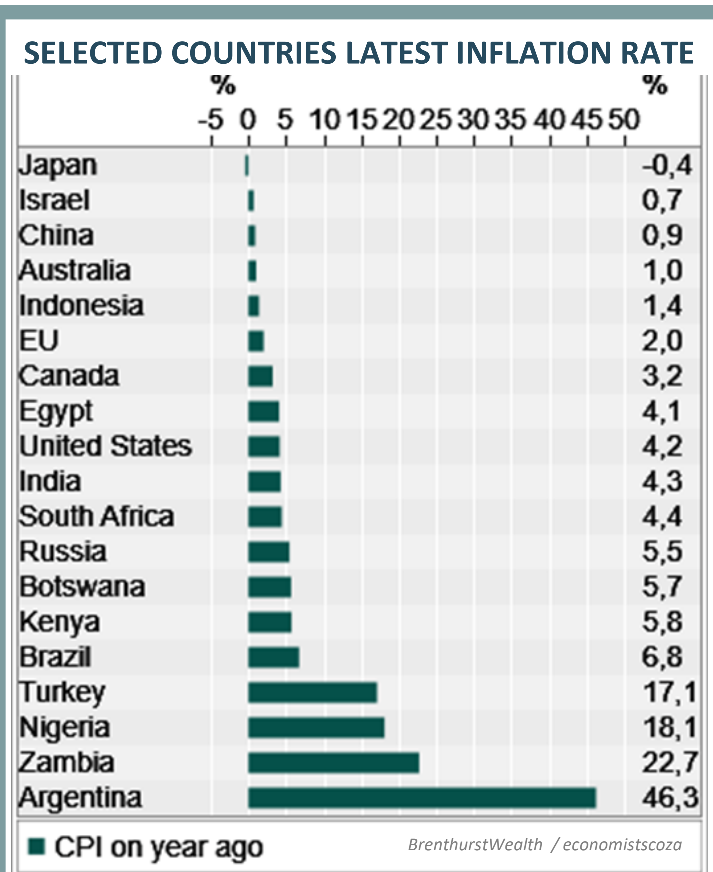
SO, THE QUESTION THAT PROBABLY KEEPS CENTRAL BANKS GLOBALLY AWAKE AT NIGHT:

Will the uptick in global CPI be cyclical or structural?

Markets seem to have priced in that higher inflation will be around for longer (structural shift to higher inflation), while the articulated view of the US Fed is that they would look through the low-base induced spike that is currently playing out and that a reaction to the current cycle is unlikely. The theme of lower-for-longer global interest rates seem to be still the narrative of central banks (while asset purchases continue unabated), while market participants are chasing a new narrative of higher-than-expected inflation and this misalignment of views have been the source of a lot of volatility on both equity and bond markets.

Rising inflation is bad for the fixed interest rate market (especially if interest rates remain unchanged), as real yields decline, while only some sectors of the economy could typically benefit from higher inflation, but only if higher inflation triggers higher interest rates for example the banking sector. In general, higher inflation erodes consumers disposable income, thus reducing purchasing power and impacting negative on consumer goods and services sectors (cyclical equities).

Graph 5:
Latest inflation rates selected countries (y/y change)



ZOOMING INTO THE LATEST TRENDS IN SOUTH AFRICA'S CONSUMER INFLATION

South Africa has followed the trend in global inflation, rising from a low of 2.1% y/y in May 2020 to the latest available 4.4% y/y in April 2021.

April was the first of two months in which the very low base of calculation will play a significant role in the outcome. In April 2020 during SA's hard lockdown the petrol and diesel prices dropped by 176c/l and 134c/l respectively, a notable drop by historical comparison. In the April 2021 CPI, we compare prices to one year earlier and thus results in a sizeable spike in the headline CPI. Petrol prices also increased by 98c/l in April 2021, thus a notable R2.74/l higher than one year earlier, resulting in fuel price inflation spiking to 21.4% y/y vs 2.3% in March 2021 and compared to -12.8% y/y in March 2020. Similarly, for the diesel price. So the spike to 4.4% y/y in the headline CPI in April 21, compared to 3.2% y/y in March, is to some extent a reflection of a low base of calculation, but also some moderate upward pressure on both food and fuel prices were detected.

Food inflation increased by 1.0% m/m and trended higher to 6.7% y/y in April vs 5.9% y/y in March, with particularly the heavy-weighted meat category increasing by a hefty 1.4% m/m and 7.1% y/y.

Oils and fats also continued to rise, 4.1% m/m and a significant 16.7% y/y (the only food category in double digits!). Core inflation, that is not subject to the low base phenomenon, also increased by more than expected to 3.0% y/y in April 2021 based on 0.3% m/m growth rate vs 2.5% in March, but still reflecting that underlying pricing pressures remain well-contained in SA, partly due to the recent strong performance of the rand exchange rate and a moderating trend in services inflation.

FORECAST:

Headline CPI is forecast to reach a near term upper turning point at around 5.0% y/y in May 21 (at the height of the low base phenomenon), before subsiding to end the year around 4.6%, averaging 4.2% in 2021 (SARB's latest forecast), somewhat higher than 2020's 3.3%, but still below the mid-point of the SARB's target band.

At its recent meeting, the South African Reserve Bank's Monetary Policy Committee decided to keep interest rates unchanged again but signalling that the next move in interest rates is unlikely to be a hike, towards end of 2021 or perhaps only in 2022, as inflation remains well under control amid a struggling economy (i.e., limited demand side pricing pressures and low pricing power among retailers) and a stronger rand exchange rate.

The SARB forecast average headline CPI at 4.2% in 2021, 4.4% in 2022 and 4.5% in 2023, clearly suggesting that local inflation is expected to remain well-behaved in the next three years, though up compared to 2020. These forecasts compare well with the Reuters consensus view of 4.1%, 4.3% and 4.4% for the three years ending 2023, with the highest forecaster in the Reuters survey expecting averages of 4.9% in 2021 and 5% in both 2022 and 2023. While global interest rates remain at historical lows, the SARB will likely use the window of opportunity to keep interest rates also lower for longer.

REASONS WHY SOUTH AFRICA'S CONSUMER INFLATION REMAINS WELL UNDER CONTROL DESPITE THE SPIKE IN COMMODITY PRICES AND HIGHER GLOBAL EXPORT PRICES:

In South Africa's CPI basket, services account for 51.3% of the weight vs goods' weighting of 48.7%.

⇒ The April's CPI print services inflation was only 2.7% y/y vs goods inflation of 6.4% y/y.

⇒ One significant reason for a moderating trend in services CPI in recent months is the impact of lower interest rates on the entry-level housing market. Instead of renting, the historical low interest rates triggered a spending boom in the entry level housing market, resulting in an oversupply of rental units, and thus plummeting rent.

⇒ Actual rent is now only 0.6% higher than one year earlier.

⇒ The recent strong performance of the rand exchange rate has been offsetting the impact of higher imported prices.

⇒ The low demand environment continues to limit retailers' ability to pass-through higher input costs to end-prices.

Graph 6:
SA inflation and the SARB forecast

TO CONCLUDE

Inflation has been trending higher, locally, and globally, and some underlying pressures are building. However, central banks are still not willing to act on the recent trends, as economies are still recovering from the Covid-19 impact and mitigating factors such as slack in the labour markets (high unemployment rates and thus moderating unit labour costs) and strong currencies (for example the rand in South Africa) are present and act to alleviate some of the pressures evident on input costs.

Also, while monthly inflation outcomes have been raising eyebrows, central banks tend to take a look at averages and longer-term trends as well as developments in inflation expectations in formulating its reaction to changing trends.

IMPLICATIONS FOR THE SA ECONOMY

Lower for longer global interest rates (current global narrative) imply South Africa remains attractive from a yield perspective. In a global environment still flush with cash as global stimulus continues, that would probably imply continuous capital flows for longer and thus sustaining the stronger levels of the rand exchange rate for longer. That in turn will continue to offset some of the upward inflationary pressures, keeping consumer inflation comfortably in the SARB's 3-6% target band.

Multi-year average consumer inflation around the mid-point of the target band, will buy the SARB some time before there is an imminent need to start the hiking cycle, thus providing further support to the local economy. And even if the SARB starts with a gradual normalisation of interest rates towards end-2021 or H1 2022, expect it to be a very gradual slow process with increases of 25 basis points at a time.

IMPLICATIONS FOR INVESTORS

This current scenario is still positive for an investment in South African bonds as long as SA 10y yields remain elevated (10y bond yield currently around 9%), while local inflation remains below/around 4.5% (base case) vs globally negative real bond yields. Furthermore, lower for longer interest rates would continue to provide some support to the economy and to households in particular, probably sustaining prospects for cyclical equities (retailers, food producers etc).

HOWEVER, ONE THING IS NOW CLEAR. KEEPING MONEY IN THE BANK OR MONEY MARKET IS CERTAIN TO CAUSE YOUR INVESTMENTS TO LOSE VALUE. YOU ARE NOW FORCED TO INCREASE YOUR RISK PROFILE AND THAT IS NOT ALWAYS THE BEST FOR EVERYONE, ESPECIALLY OLDER INVESTORS.

Bonds are an option, but you would want short-term bonds if a more risk adverse situation persists. But generally, the higher inflation and low interest rates are not conducive for increasing or even maintaining your wealth and assets. With rates forecast to stay lower than inflation for at least the next six month or so this will be the first time in decades that money market returns will be negative in real terms. After tax for richer investors, it is even worse. Time to talk to your financial advisor and not bank manager.

But what if the base case does not realise… inflation surprising notably to the upside.

In the event that markets are correct, and the US Fed changes course abruptly, what could play out?

The US Fed will probably announce a tapering of its bond purchases first, reducing the ongoing cash injection into the economy, to be followed later by a gradual uptick in US interest rates.

US bond yields will likely rise pricing in a lot to come, which will knock equity markets globally, while also reverting capital away from emerging markets to the US, in the process probably strengthening the US dollar, while weakening emerging currencies like the rand. If you believe that this scenario has a high likelihood to play out (not currently the base case), now might be a good time to broaden the diversification of your portfolios underexposed to inflation dynamics. Traditionally, defensive sectors fare well when consumers' disposable income comes under more pressure for example pharmaceuticals and food, and based on a pure play on inflation dynamics, the gold sector should remain attractive.

We will be reminded of the fact…*if the US sneezes the rest of the world will indeed catch a cold!*

Compiled by Brenthurst consulting economist **Mike Schüssler** and independent economist **Elize Kruger.**

As part of Brenthurst Wealth commitment to review the best research available to serve our clients, we appointed award-winning independent economist Mike Schüssler as our consulting economist.

BRENTHURST OFFICES:

Johannesburg	+27 (0) 11 799 8100	**Claremont**	+27 (0) 21 418 1236
Sandton	+27 (0) 10 035 1391	**Bellville**	+27 (0) 21 914 9646
Pretoria	+27 (0) 12 347 8240	**Stellenbosch**	+27 (0) 21 882 8706
Cape Town Waterfront	+27 (0) 21 418 1236	**Val de Vie Estate**	+27 (0) 21 100 3901
		Mauritius	00 230 5843 5215

BRENTHURST SATELLITE OFFICES:

GARDEN ROUTE | KWAZULU-NATAL | FREE STATE | MPUMALANGA | NORTH WEST