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IN THIS ISSUE

**MIKE SCHÜSSLER, SA AWARD
WINNING ECONOMIST
PASSED AWAY 24 MAY 2022.**

*This newsletter written in
conjunction with Elize Kruger
is dedicated to Schüssler,
consulting economist to
Brenthurst Wealth for the
past three years.*

*We salute a great mind
and all-around magnificent
person. R.I.P.*

**INVESTING WITH SA'S
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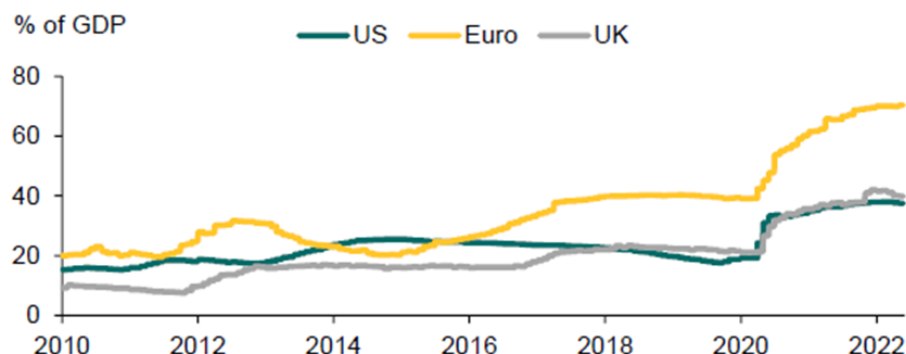
INFLATION, STAGFLATION AND INTEREST RATES

By Mike Schüssler, Brenthurst Wealth Consulting Economist, and Elize Kruger

In the years that followed the global financial crisis in 2008/09, the question was often asked...*Why has the extent of quantitative easing not resulted in runaway inflation?*

Surely, the sheer extent of money created in the major developed economies (see graph below), with central banks embarking on extensive asset purchasing programmes (or referred to as quantitative easing) would have led to higher inflation... A theme of many dinner table discussions, with the answer probably to be found in the fact that the surplus cash, created in those economies, was redirected to higher-yielding investment destinations (not to services and goods in the respective local economies). The beneficiaries typically were developing economies where higher returns are on offer, which remains attractive even despite the higher risk environment, for example as reflected in sub-investment grade sovereign ratings. South Africa's bond market has also been a beneficiary of this trend in recent years.

Central bank balance sheets (% GDP)



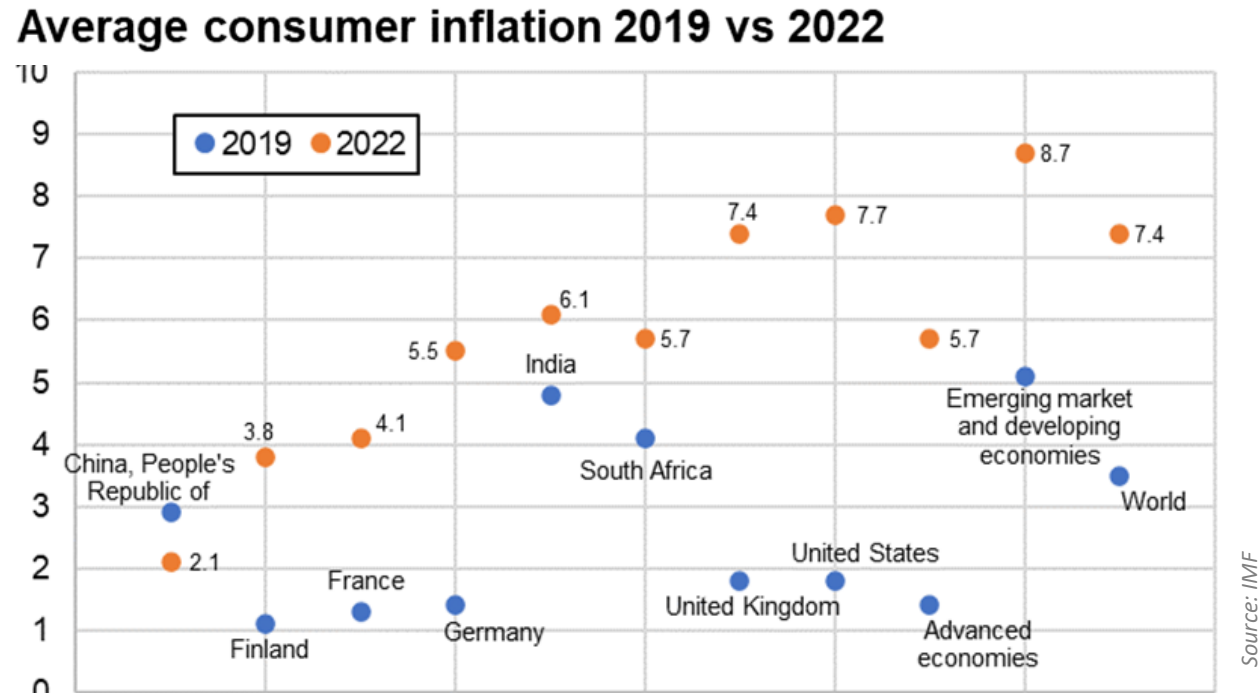
Source: RMB markets

But global inflation did eventually rear its ugly head... but it took major (and actually multiple) supply chain disruptions to trigger global inflation to accelerate notably and to the extent that it is now threatening growth prospects across the globe. The unprecedented economic contraction that played out in 2020 (in reaction to the Covid-19 pandemic) laid the table for a notable V-shaped recovery in 2021, driven by the opening of economies after hard lockdowns (and the low base of calculation). While the global economy recovered, the recoveries were uneven across the different regions of the world (partly due to differentials in countries’ vaccination rates) and the strong demand scenario was realised against a background of sluggish supply growth and notable supply chain disruptions. Not only were certain products, such as micro-chips, in short supply, but the cost to transport products across the globe spiked to unprecedented levels due to the unavailability of cargo ships, travel routes being closed and higher fuel prices.

These costs became embedded into product prices. Just as the global economy started to gain notable momentum post-Covid, while supply chain pressures started to abate, the conflict between Russia and Ukraine erupted, once again disrupting supply chains and resulting in rocketing food and fuel prices. Particularly given Russia’s importance as an energy and commodity exporter and Ukraine’s importance in terms of food production and exports.

In the US, consumer inflation increased from a mere 0.3% y/y in April 2020 to 4.2% y/y one year later in April 2021 and 8.3% y/y in April 2022, now around a 40-year high. Although inflation was already in a strong upward trajectory at the time, Russia’s decision to invade Ukraine in February 2022 added renewed upward pressure on commodity prices, particularly energy prices, and also many food items spiked to record levels, while supply chains were hit again.

Rising inflation is now firmly entrenched in many countries across the globe, as illustrated in the graph below. The comparison is done between 2019, the last “normal” year before Covid-19 hit the global economy and 2022, the first “normal” year post-Covid.

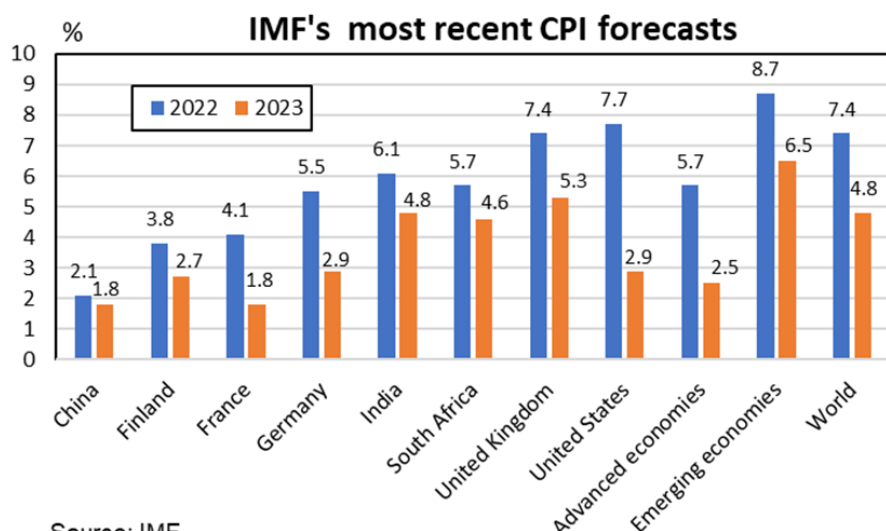


The impact of this double-whammy (Covid and Russia-Ukraine conflict) on price developments that have been playing out in the global economy turns out to be a game-changer with regard to inflation. Central banks, among developed and developing economies, have started to react to the rising inflation rates by tightening monetary policy. The US Fed raised its benchmark interest rate by 50bps early in May and signal more hikes to come as the US Fed Chairman, Jerome Powell, said he would keep raising rates until there is “clear and convincing” evidence that inflation is in retreat. Higher inflation erodes the disposable income of households and ignites higher wage demands, while the central banks’ typical response of hiking interest rates, will cumulatively all contribute to further downward pressure on economic growth. These pressures are also on top of the downward pressure following the impact of the war, which has disrupted trade and resulted in sanctions against Russia. In its latest World Economic Outlook published in April 2022, the IMF downgraded global growth prospects to 3.6% for 2022, down 0.8 pp from the previous views published in January 2022.

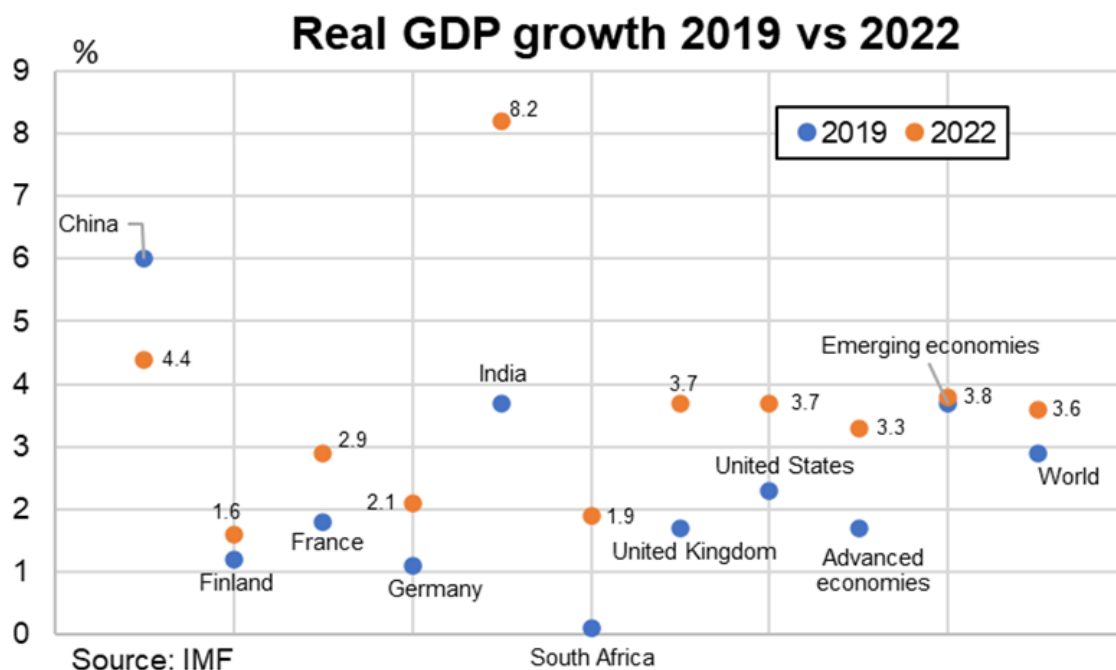
It is thus no wonder that stagflation is the talk in town. Stagflation (a term that combines the words stagnation in GDP and inflation) refers to an economy experiencing significant inflation, high unemployment and slow to no economic growth.

This noxious triple combination is the worst-case scenario for central bankers and lawmakers, who will have to choose which ailment to fight. Policy makers across the globe are now indicating that prices are their primary concern even if that battle curbs demand and hiring. While the prospects for a synchronised global recession remain low at this stage, the pace of events is catching policymakers and investors off guard as financial markets recently slumped and growth forecasts continue to be revised lower. Concerns about rising global inflation and the magnitude of monetary tightening required to rein this in sent global equity markets sharply lower in recent weeks. US stock markets booked huge losses as the S&P 500 was, at one stage, trading 20% lower than its high in January 2022, meeting the official definition of a bear market, but retraced again to higher levels.

While markets have been volatile amid concerns about a prolonged period of stagflation in the world economy, the concerns might prove to be somewhat exaggerated, at least if one considers the IMF’s most recent inflation forecasts for 2022 and 2023, as depicted in the graph below. The IMF forecasts that consumer inflation in all the major developed economies and for the globe as a whole will reach upper turning points and moderate into 2023. This is arguably based on the reality of central banks removing stimulus from their economies, by phasing out quantitative easing and hiking interest rates.

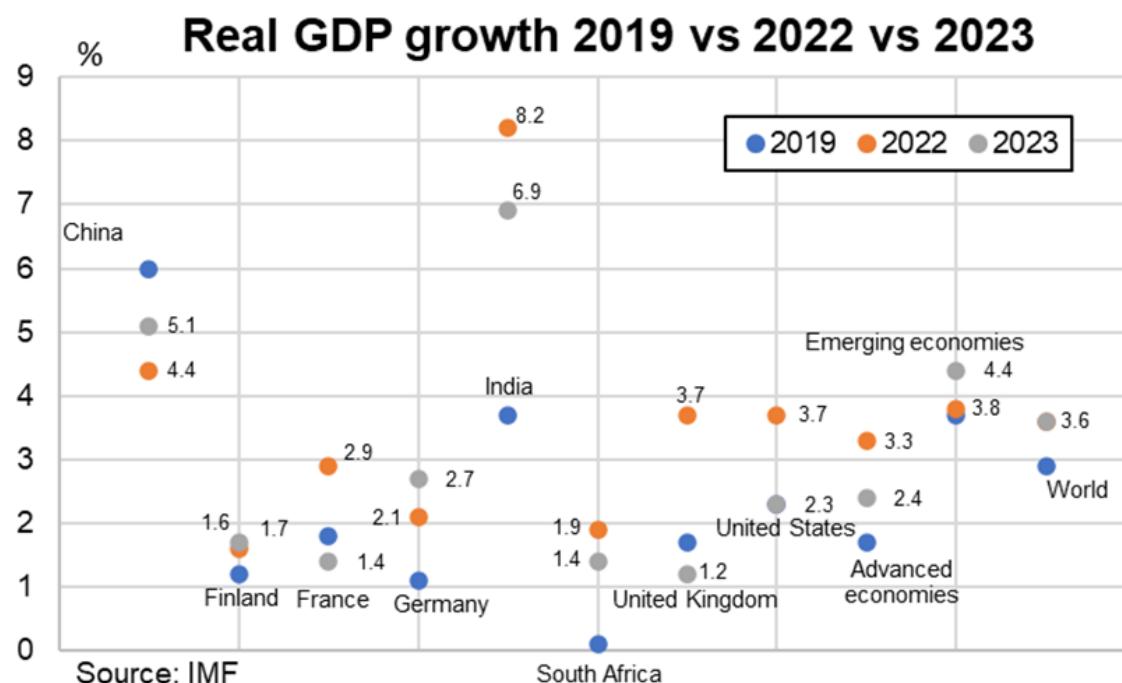


Furthermore, in 2022 real GDP growth rates are generally still fairly strong, not nearly to be described as a "slow or no growth" environment—see graph. In this selection, the only country where real growth is lower in 2022 than in 2019 is China. The slowdown in China occurred amid their government’s aggressive covid-zero policy, hitting manufacturing production, trade activity and consumer spending.

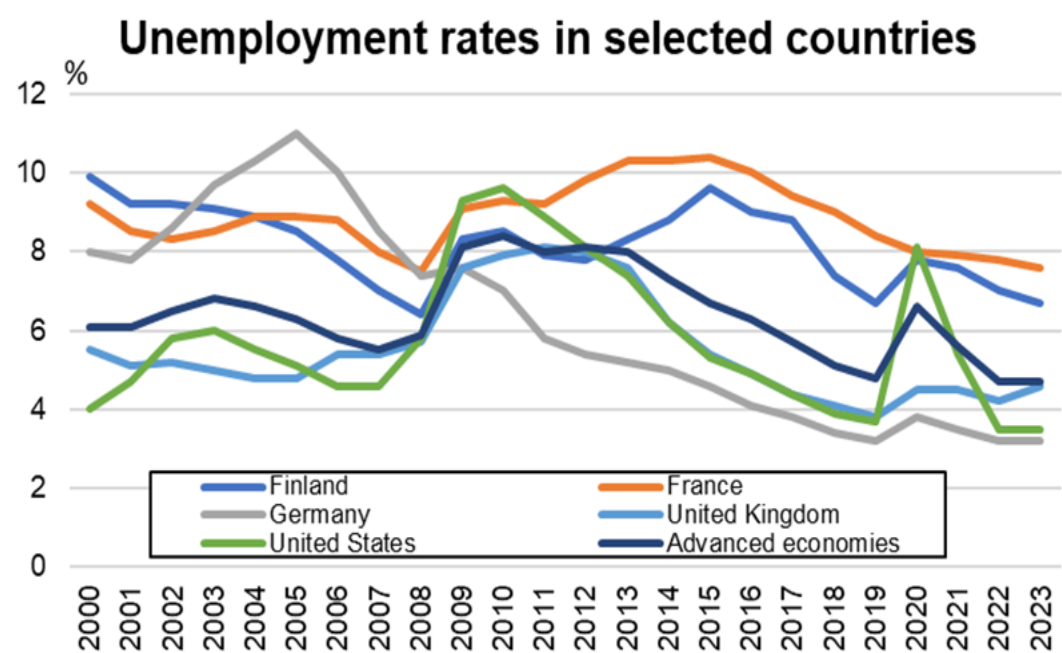


So perhaps the growth effect will only come through in 2023, as the impact of higher inflation and interest rates filter through to the respective economies.

From the graph below, it is clear that a notable moderation is expected in the growth of some economies like the US, UK and France, but to a lesser extent in emerging economies, while growth in China is forecast to be higher and overall, global growth is forecast to remain unchanged at 3.6% in 2023. Thus, some economies may feel the pinch of high inflation and a lower growth environment more than others, perhaps for a shortish time period, but a scenario of prolonged global stagflation seems to be some way off.



If one considers the trend in unemployment rates of selected countries, it is clear that unemployment rates in developed economies are fairly low and not forecast to increase notably in 2023. For example, the unemployment rate in the UK edged down to 3.7% in Q1 2022, the lowest reading since 1974.



With China’s economy slowing sharply amid Covid-related lockdowns in the early months of 2022, while the US Fed stepped-up its vow to crush inflation, investors’ worries about a widespread hard landing is probably justified. However, outright stagflation, in the pure sense of the definition, is not the base case and current forecasts, particularly on inflation moderating again in 2023 and unemployment rates remaining quite low, mitigate those fears.

SO, WHAT ABOUT SOUTH AFRICA, DO WE TICK THE STAGFLATION BOXES?

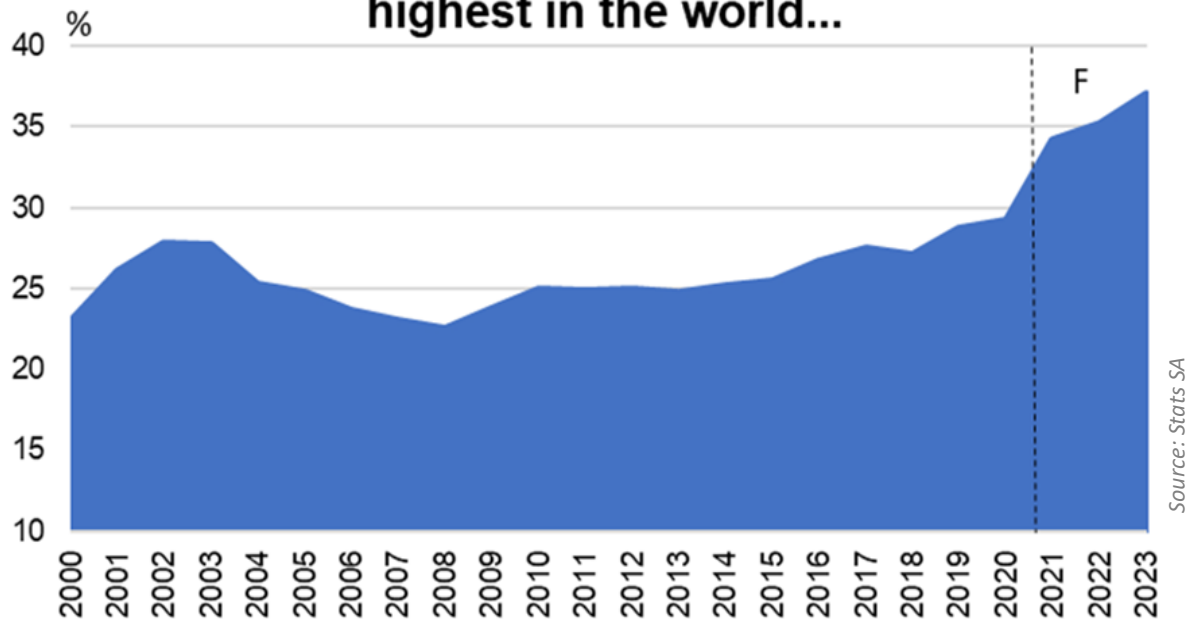
✓ HIGH UNEMPLOYMENT RATE

South Africa is in a unique predicament of its own, with our unemployment rate the highest in the world. While the economy recovered to some extent in 2021, with real growth of 4.9% recorded after the recession of 2020 (-6.4% contraction in 2020), the job market has not shown similar growth compared to the broader economy.

By Q4 2021 total employment levels were still 479 000 lower than one year earlier, while the number of unemployed persons increased by 688 000. Although many job losses were centred on lower-income individuals, there was also a section of the formally employed population that were hit by retrenchments, downscaling, furloughing and an inability to find suitable employment in the aftermath of the pandemic.

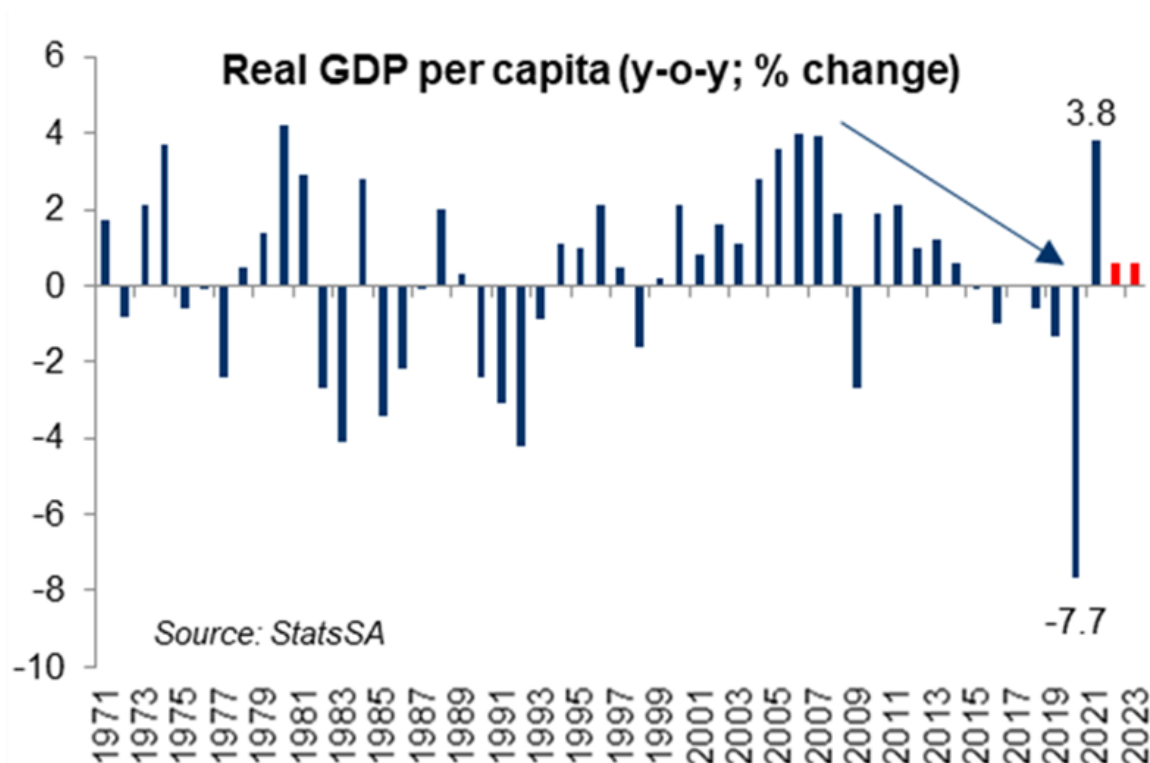


South African unemployment rate is the highest in the world...



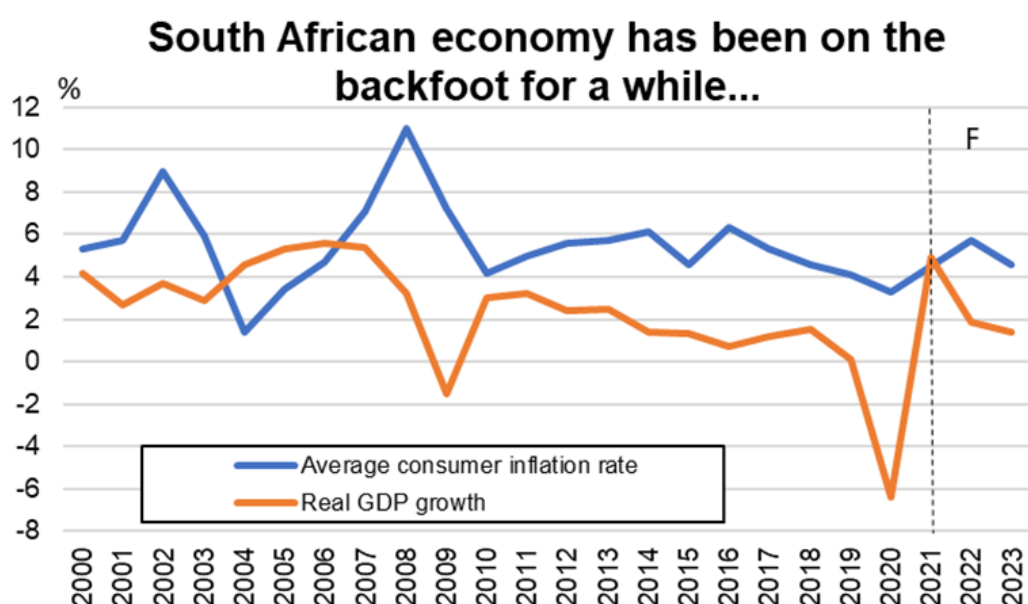
✓ SLOW OR NO GROWTH

The average real economic growth rate in the ten years to 2019 was only 1.7% per annum, while population growth averaged 1.5% per annum over the same period. This resulted in dwindling growth in real GDP per capita, with outright contractions between 2015 and 2020, signalling that average South Africans have become poorer for each of those years – see graph below. In 2021, real GDP per capita recovered somewhat, but remains notably below previous years' levels in nominal terms.



According to the IMF's latest World Economic Outlook, published in April 2022, mediocre real growth of 1.9% is forecast for 2022, but only 1.4% is forecast on average for the five years to 2027, with several notable risks and ongoing hampering factors that will continue to keep a lid on growth in South Africa:

- ⇒ Ongoing electricity supply issues resulting in intermittent periods of load shedding, with Eskom indicating recently that South Africa should prepare for 5 more years of regular load shedding.
- ⇒ The strain on household finances due to rising fuel prices, food prices and rising administered prices (notably hefty electricity, water and other municipal tariff increases effective 1 July).
- ⇒ High unemployment with little prospect of a notable turnaround amid the mediocre recovery. Youth unemployment (15-24yr) at a staggering 63.9% in Q1 2022 vs total economy unemployment of 34.5%.
- ⇒ Low confidence levels amongst consumers and businesses.
- ⇒ Slow progress on structural reforms that could lift the potential growth rate of the economy.



✓ HIGH INFLATION

Domestic inflationary pressures increased in recent months, with both headline consumer and final manufactured producer price inflation accelerating to above the midpoint of the inflation target range (3%-6%). This largely reflected a surge in fuel and raw material prices, as well as higher food and electricity prices.

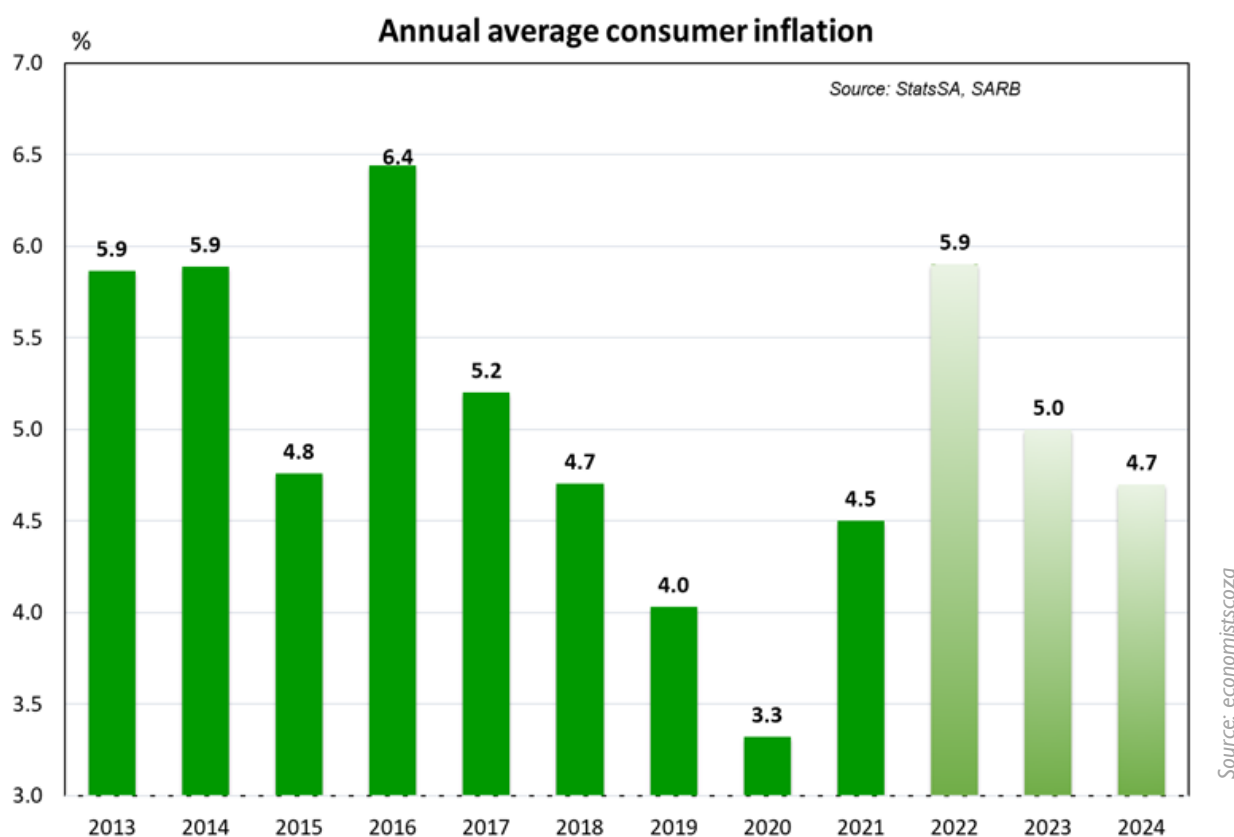
Headline consumer price inflation accelerated to 5.9% in April 2022, while final manufactured producer price inflation accelerated to 13.1%, the highest since 2011, due to significant increases in fuel and food prices.

Intermediate manufactured goods price inflation, which feeds into the supply chain to determine final manufactured prices, accelerated to an all-time high of 23.1% in December 2021, before subsiding to 17.6% in April 2022.



Headline CPI is forecast at 5.9% in 2022, somewhat higher than 2021's average of 4.5%, but still within the SARB's 3% - 6% target range. **However, the consumer price index (CPI) rose 6.5% in May, breaching the Reserve Bank's upper limit of 6%. This is the highest reading since January 2017, although it is likely to subside again in months ahead.** While headline inflation is currently predominantly driven by higher fuel prices, the underlying pricing pressures in the economy remain well contained in South Africa, given the subdued consumer demand. Core inflation fluctuated between 2.5% and 3.4% during 2021 and averaged at only 3.1% compared to 3.3% in 2020 and notably lower compared to headline inflation's average of 4.5%. However, the SARB's latest core inflation forecast for 2022 is 3.9%, though still moderate, it suggests some underlying pricing pressures are starting to gain traction in the South African economy.

WHILE INFLATION IN SOUTH AFRICA IS FORECAST TO REMAIN WITHIN ACCEPTABLE LEVELS, MANY UPSIDE RISKS NEED TO BE MONITORED. THESE INCLUDE FURTHER INCREASES IN FUEL PRICE, GIVEN ELEVATED LEVELS OF INTERNATIONAL OIL PRICES, HEFTY ELECTRICITY TARIFF INCREASES AND THE RISK OF SECOND-ROUND PRICE INCREASES AS COMPANIES ARE GENERALLY UNABLE TO ABSORB THE FULL EFFECT OF HEFTY COST INCREASES THAT ARE PLAYING OUT.



In line with global inflation trends, South Africa's headline inflation is also forecast to moderate from 2023 onwards. Furthermore, the South African Reserve Bank (SARB) has already embarked on the process of normalization of monetary policy (by hiking interest rates gradually), which should assist in reigning in higher inflation expectations.

To conclude, the current realities in South Africa do point to a period of potential stagflation, given recent upward pricing pressures. However, if consumer inflation does reach an upper turning point later this year, as expected, and moderates into 2023, it should trigger only a moderate interest rate cycle and provides the government with a window of opportunity to address the structural issues that are holding the economy back.

THE CONSEQUENCE OF STAGFLATION?

So, while it seems like all the boxes are not ticked for stagflation in the strict definition of the word (not for the globe and not for SA per se), in certain economies and perhaps only for a short time period, the set of circumstances will feel like stagflation and worth dwelling on what the consequence of stagflation could potentially be.

WHAT ARE THE CONSEQUENCES OF STAGFLATION FOR REGULAR PEOPLE?

When stagflation occurs, it has a direct impact on affordability making it harder for many to meet basic needs, especially those who are among the low income or unemployed. For those who are employed, stagflation could lead to risks of job losses and lower wages, which would decrease consumer confidence and purchasing power.

WHAT ARE THE CONSEQUENCES OF STAGFLATION FOR INVESTORS?

Stagflation generally results in lower profit margins due to higher input costs and lower sales. Stagflation can thus directly impact investors by decreasing the growth in companies' earnings per share, which impacts stock prices. Dividend investors may also be negatively affected as companies reduce or suspend their dividends to conserve cash. For those who invest in growth stocks, there could be significant losses as many have expected growth targets priced into their equities that stagflation would make harder to meet. If stagflation occurs long enough, some companies might go bankrupt causing significant investor losses.

However, there are ways that investors can hedge the risk of inflation, including funds that are designed specifically to navigate high inflation periods. Investors that are worried about the impact of potential stagflation on their portfolios might want to shift their investment strategy and need to liaise with a financial advisor.

MIKE SCHÜSSLER, AWARD WINNING SOUTH AFRICAN ECONOMIST PASSED AWAY 24 MAY 2022.

As an independent economist, Mike Schüssler was in a class of his own. He wrote about complex economic realities, and economics in general, in a way that ordinary people could understand and relate to. His research was unparalleled, his insight highly regarded.

Brenthurst Wealth worked with Mike for decades. He was a popular speaker at our client events and more recently on webinars. As consulting economist to Brenthurst, he wrote reports of an exceptional standard that contributed to both our clients' and our team's understanding of economic issues and the impacts on investment decisions. Beyond his professional career, he was an extraordinary person. Sociable, entertaining and engaging on diverse topics. He will be greatly missed. Our condolences to his family and his team at Economists.co.za.

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