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The Outlook

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- Ray Dalio on long-term cycles and the three wars to take heed of.
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- Embarking on his third term, Xi Jinping refers to a "term of unparalleled complexity".
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Ray Dalio – forces changing economies and the world order

In a recent podcast, Ray Dalio, co-founder of US hedge fund Baywater Associates noted that the relative peace and prosperity enjoyed by many under the US-led world order since WWII now face a series of challenges. Dalio added that the consequences of a prolonged period of prosperity are a significant build-up in global debt, growing intra-country conflict around income, wealth and health gaps and competition to the US as the dominant global power.

Dalio is big on ultra-long-term cycles and outlined five forces that global investors should take heed of:

- the high levels of debt and money,
- increasing internal conflict *within* countries over money and values and populist uprisings,
- US hegemony is being challenged by China and Russia,
- acts of nature – droughts, floods, pandemics, and
- human inventiveness and the ability to adapt.

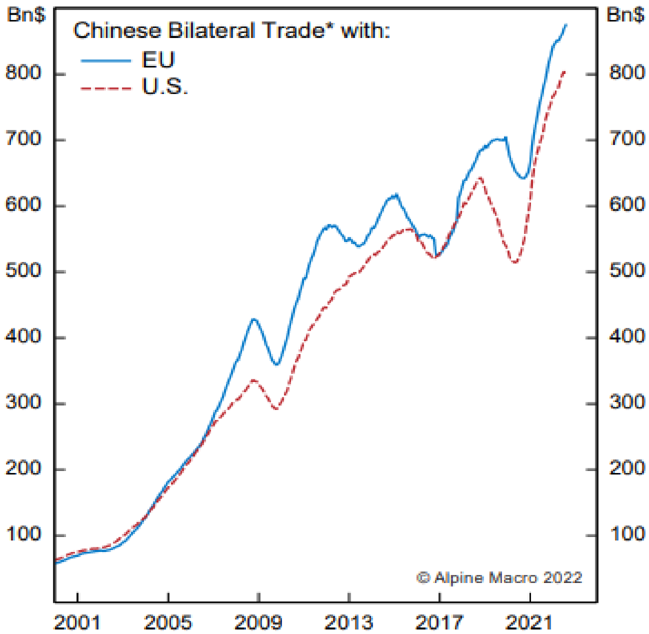
Dalio highlights three types of wars that should concern investors. These are trade wars involving sanctions, civil wars like not accepting election outcomes and physical wars with the Russian/Ukrainian conflict being a prime example.

Alpine Macro – The Chinese Emperor at a crossroads with Europe

In its Feature Report – The Chinese Emperor at a crossroads with Europe – dated 17 October 2022, Alpine Macro concludes that after centuries of trade between Europe and China, "*we are probably standing at an inflexion point again in the Europe-China relationship. While the West is decoupling from Russia, Europe will want to actively engage with China and that the multi-dimensional interdependencies are too big to fail*" – see the chart which follows. However, "*the Chinese government needs to clarify its "no-limits" relationship with Russia. This is an absolute prerequisite for a continued constructive relationship, especially from a European perspective*". China meanwhile, will have to consider the benefits of discounted oil (-$25.5/bl), gas and metal supplies from Russia.

> *Russia's energy blackmail will only harden its geopolitical resolve and lead to a complete European decoupling from Russia*

Sino-Europe trade in perspective



*Sum of imports and exports; shown as 12-month moving total

However, as Alpine Macro points out, "*the enemy of the enemy is always your friend – with the US coming down hard on both China and Russia, it is all too natural to see Beijing and Moscow come together and defend one another*". We watch with interest to see where South Africa's allegiance lies.

On Europe, Alpine Macro says, "*Russia's energy blackmail will only harden its geopolitical resolve and lead to a complete European decoupling from Russia*". The EU, meanwhile, faces an energy crisis, annual inflation of almost 10%, and now a 75bp rate increase.

All in all, investors have a heavy dose of geopolitical tension to cope with in addition to sluggish global growth

High levels of inflation and rising interest rates together with the geopolitical tensions between the US, Europe, the UK, Russia, and China have significantly lowered the prospects for global growth. But as these tensions unravel in the coming months, energy, food, and logistics prices may remain stubbornly high due to supply constraints. In turn, this begs the question of how hard and high the Fed and other central bankers will push interest rates.

20th CPC National congress

During last week's congress, Xi Jinping strengthened his power base, dictator-like, by being elected for a third term as president. He also gained strong support for the implementation of "*Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era*"

In introducing four younger faces with experience in science, technology and security to the Politburo Standing Committee, Xi Jinping referred to "*a term of unparalleled complexity".* He also promised, "*inclusive growth and greater equality, the use of technology and AI to achieve growth and sustainability and the need to focus on internal and external matters building a better world*".

Concerning Taiwan, Xi Jinping said, "*we should take resolute steps to oppose 'Taiwan independence' and promote reunification, maintain the initiative and the ability to steer in cross-Strait relations, and unswervingly advance the cause of national reunification"*.

US inflation and the Fed's next move

As indicated above, the US is in a trade and sanction war with China and is at odds with China over Taiwan. The US is also the protagonist and lead funder in the Ukrainian war against Russia, it has unresolved issues with Iran over its nuclear ambitions, and has turned on Saudi Arabia over OPEC+ oil cuts.

All in all, investors have a heavy dose of geopolitical tension to cope with in addition to sluggish global growth. As much as earnings growth is important, we sense that the US equity market is going to be more driven by the Fed's interest rate moves, at least in the short term.

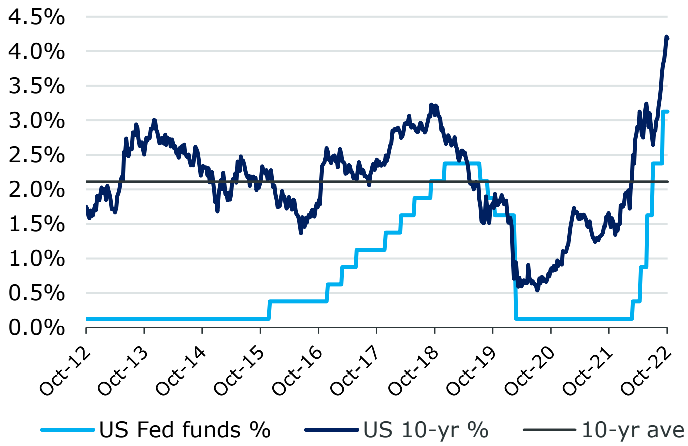
The following chart indicates that once the Fed convinced itself that the inflation was not transitory, it raised the funds rate dramatically, +2,400% from 0.13% to 3.2% in a matter of months. The market expects the Fed to raise rates next week by another 75bps and again in December to eventually peak around 4.75% in 2023.

The market in turn has chased the US 10-year yield, in near vertical fashion, to above 4%.

Such a rapid rise in interest rates has spooked the equity market and could choke off demand. However, Fed presidents Mary Daly and Lael Brainard are cautioning on a Fed rate overkill.

So where/when will the Fed stop? We may see a slowing of the economy, but inflation may not fall as much as the Fed would like and yet Powell may no longer be able or willing to raise rates further. The market will be watching closely to see how the Democrats fare in the November 8 mid-term elections.

US Fed funds rate & 10-year yield



Source: Refinitiv

Year-to-date the S&P 500 and the Nasdaq are down -19% and -30.2% respectively, whereas the JSE ALSI in dollars is down -18.8% and gold is down -9%. We expect volatility to remain intense as investors zone in on next week's Fed meeting, looking for the slightest clue to the end of the Fed's aggressive monetary-tightening campaign.

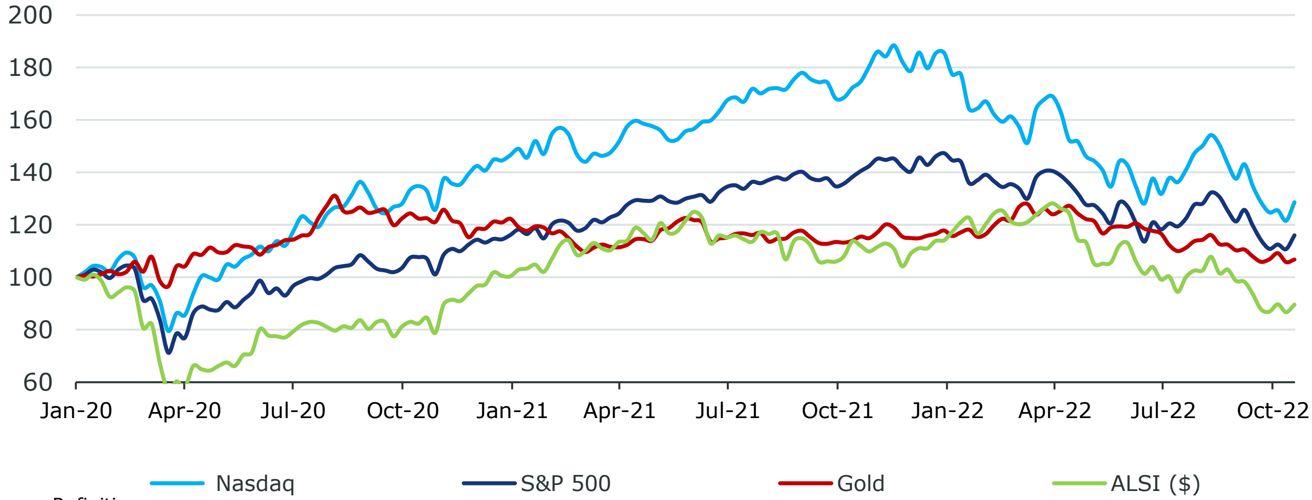
South Africa – Mid-term budget and public sector wage crisis

In the Mid-Term Budget, Minister Godongwana referred to the myriad of global challenges listed above and acknowledged the massive windfall in tax revenues from the commodity boom. Revenues for 2022/23 are estimated at R1.68tn and total expenditure at R2.2tn leaving a deficit of R523bn. The total net national debt is projected to increase by 12.3% to R4.5tr, of which 12.4% is foreign.

Debt service costs of R308bn now account for 14% of estimated tax revenues, whereas government employee wages at R693bn account for 31.4% of revenues. With a total headcount of 1.76m and a wage bill of R791bn (including local government), the average government wage is R447k per year or R37,285/month. And yet the Public Sector Association (PSA) has served Minister Thulas Nxesi with a 7-day strike notice and COSATU is demanding a 10% increase.

The minister has allocated the following amounts to distressed SOEs: R23bn to settle SANRAL debts, R5.8bn to Transnet to repair infrastructure and locos, R3.2bn to reduce Denel liabilities, a conditional R5bn for the Land Bank and between R130bn and R260bn to settle Eskom debt.

S&P 500, Nasdaq,ALSI, Gold (December 2019 = 100)



Source: Refinitiv

By now the message that taxpayers' patience is wearing thin is slowly being realized by some government ministers. Transnet is a case in point. The summary below indicates Transnet's average labour costs in recent years. As with Eskom, Transnet's rail and port services are what make the economy function. Due to poor management and maintenance, theft and vandalism the Richards Bay Coal Line have probably lost coal miners about R55bn in revenues year to date. And similarly, large numbers apply to all the other major rail lines and ports. Value for taxes paid is just not happening.

Transnet - annual average labour costs in Rm					
Year ended March	**2018**	**2019**	**2020**	**2021**	**2022**
Revenue	72,887	74,070	75,065	67,273	68,459
- Energy costs	6,781	7,342	7,698	6,660	8,002
- Maintainance costs	1,717	1,721	1,221	2,222	2,392
- Material costs	1,139	1,454	699	426	803
- Personnel costs	23,491	23,806	23,277	24,210	26,194
- Other costs	7,244	5,997	8,186	14,295	7,619
EBITDA	32,515	33,750	33,984	19,460	23,449
Net profit/(loss)	**4,851**	**6,047**	**3,938**	**-8,734**	**5,048**
No of employees	51,324	50,798	50,560	49,642	46,086
Ann ave/employee	**457,700**	**466,227**	**459,303**	**483,224**	**547,259**
Mth ave/ employee	**38,142**	**38,852**	**38,275**	**40,269**	**45,605**

South Africa – opportunities staring us in the face

The many challenges and headwinds buffeting global economies could be an opportunity for South Africa. Under the COP26 agreement, the EU and the US have pledged $8.5bn towards our Just Energy Transition. Combine this with the EU financing agreement that is going out to tender to finance the Sustainable Infrastructure Development of South Africa and there is endless work and opportunities on the horizon. But, only if the President and his cabinet focus on fixing the SOEs and let the private sector do what it is good at doing. Watch this space.

Year-to-date the FINI 15 is up 5.4%, the ALSI -8.9%, the RESI 20 -10.3%, the SAPY -13.8%, and the INDI -17.5%. Year-to-date the rand is down -11.4% against the US dollar, which has risen by 17% against the basket of major global currencies.

ALSI and major JSE indices (December 2016 = 100)

Source: Refinitiv

It is likely that the Fed will again increase the funds rate by 75bp next week, but global investors will be hoping for a clue that the economy has sufficiently slowed and that we are near the top of the rate cycle. There are still many reasons to be cautious, but the interplay between a slowing economy and peak rates may happen sooner than the market thinks.

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