Market Synopsis – May 2022

A painful road ahead for equities?

May was a challenging month for equities – in USD terms the MSCI world index fell by more than 4%, and the JSE declined by 0.4%. This has unfortunately been a continuation of the trend noticed since the beginning of 2022, and has pushed global equities closer and closer to bear market territory – see Figure 1.

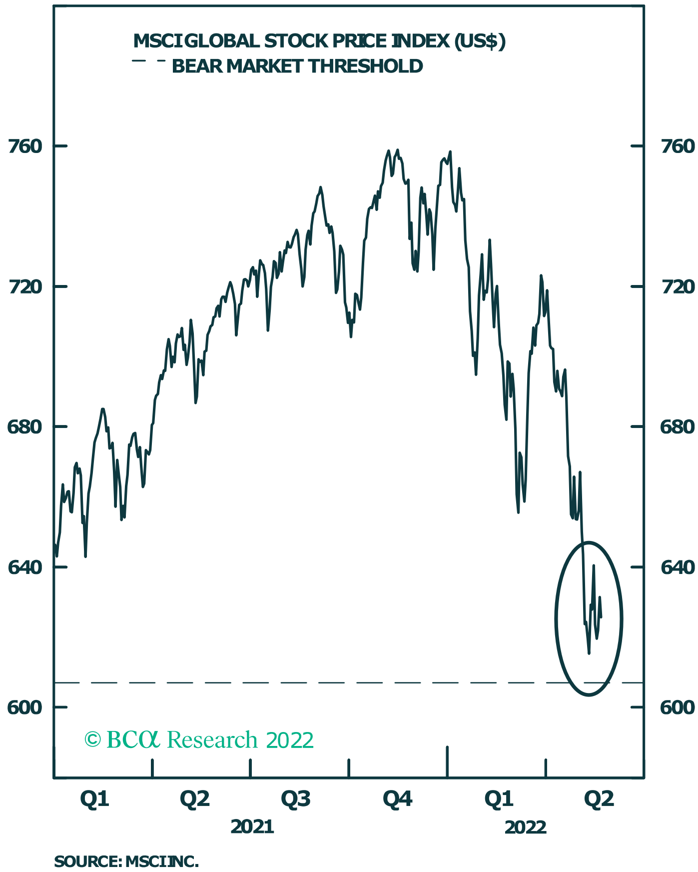


Figure 1 – MSCI All Country World Index

Global equities are down 12.8% since the beginning of the year, and the outlook for equities has continued to deteriorate. However, this downtrend is consistent with risk's identified in prior newsletters, and has largely been priced into the equity market. Based on this, we believe investors should remain overweight risky assets. This view point centres on three expectations: The US will narrowly avoid an actual recession, but still experience a significant recessionary scare; Russia will continue to pump natural gas to its European partners; and the Chinese government will enact a significant stimulus program in either a continuation of prior Chinese programs, or an income supportive policy similar to what occurred in the US.

Pay close attention to the factors listed above, as the confirmation of all by the end of the year would be an incredible boon to equity prices. However, failure to meet any of these expectations will fuel the current fear based selloff and lower expected equity performance.

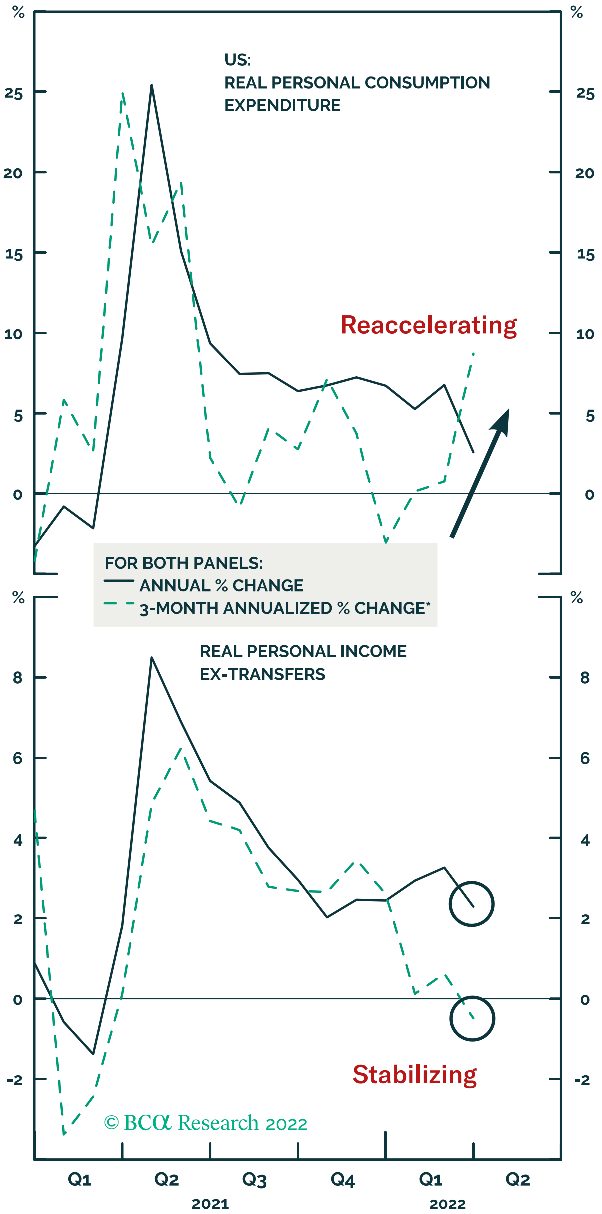
A US recession – valid or fearmongering?

As mentioned in our April newsletter, we believe that the US is going to experience a recessionary scare, but will ultimately avoid entering prolonged recession territory. While the performance of equity markets in 2022 may contradict that statement, several factors back up our viewpoint.

The Federal Reserve Bank of Atlanta's real GDP growth model is currently predicting Q2 growth only slightly below its historical trend, which is being significantly lowered by the negative contribution from changes in private inventories. Without the negative impact of inventory, the model would be predicting a real annualised level of growth over 3%. After slowing drastically in Q2 2021, due to increases in consumer price inflation, real personal consumption expenditures have begun to accelerate and real income has stabilised – see Figure 2 on the following page.

US manufacturing production, more specifically motor vehicle production, surged in April. While this type of production is a coincident indicator, and therefore does not rule out an imminent recession, the increase in production does indicate that the 15% spike in new vehicle prices experienced over 2021 is set to reverse, alleviating some inflationary pressures on consumers.

Service spending, which drastically slowed during the height of the pandemic, is likely to continue to improve as deliveries of Paxlovid (an antiviral drug shown to be incredibly effective in reducing Covid-19 related hospitalisations) ramp up, and vaccines are approved for children under 6. Spending on many service related industries remains lower than their pre-pandemic levels, and are expected to normalise and improve further over the next 2 years as the world returns to normality – see Figure 3 on the following page.



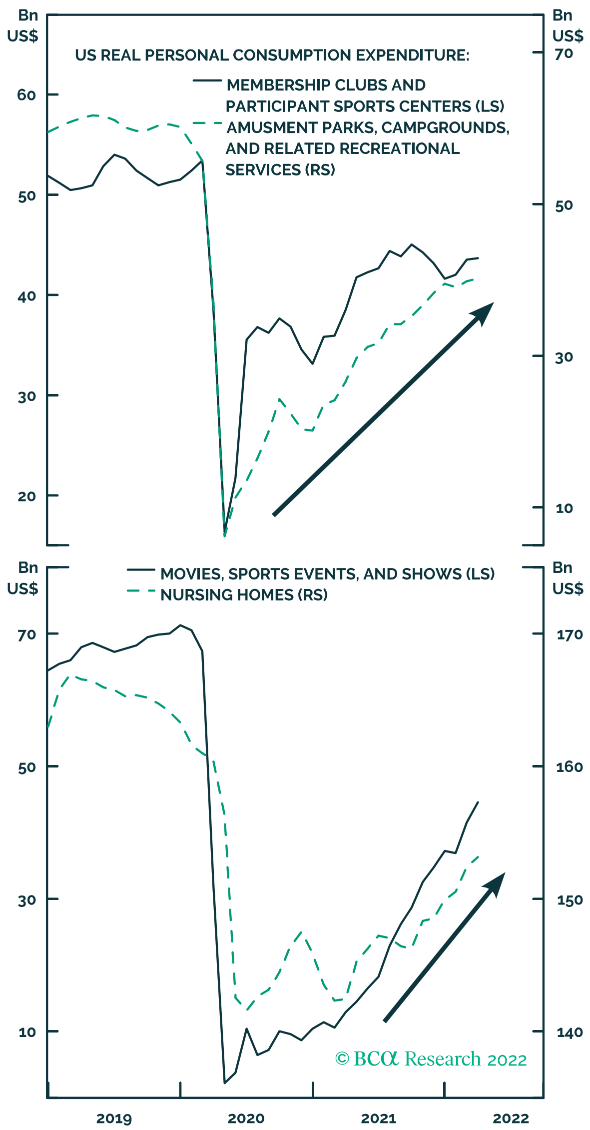
SOURCE: BUREAU OF ECONOMIC ANALYSIS.
* SERIES TRUNCATED AT +25.

Figure 2 – Real personal consumption expenditure & personal income

Finally, recent inflation expectation indicators are encouraging and point to an end of Fed hawkishness. Long-term market based inflation expectations have decreased, and the increase in core consumer prices has slowed. The market is currently pricing in interest rate hikes far higher than what Jerome Powell suggested during the Fed's May press conference. Market expectations for potential rate hikes will fall over the coming months if core inflation continues to slow.

Europe's energy woes

The key consideration in evaluating Europe's outlook is whether natural gas imports from Russia will continue or not. A European embargo on Russian oil is being implemented, which will cause production to slow and prices to rise. If this occurs, prices will likely hover around USD120-USD125/bbl for the remainder of the year – see Figure 4 on the following page.



SOURCE: BUREAU OF ECONOMIC ANALYSIS.

Figure 3 – US service spending

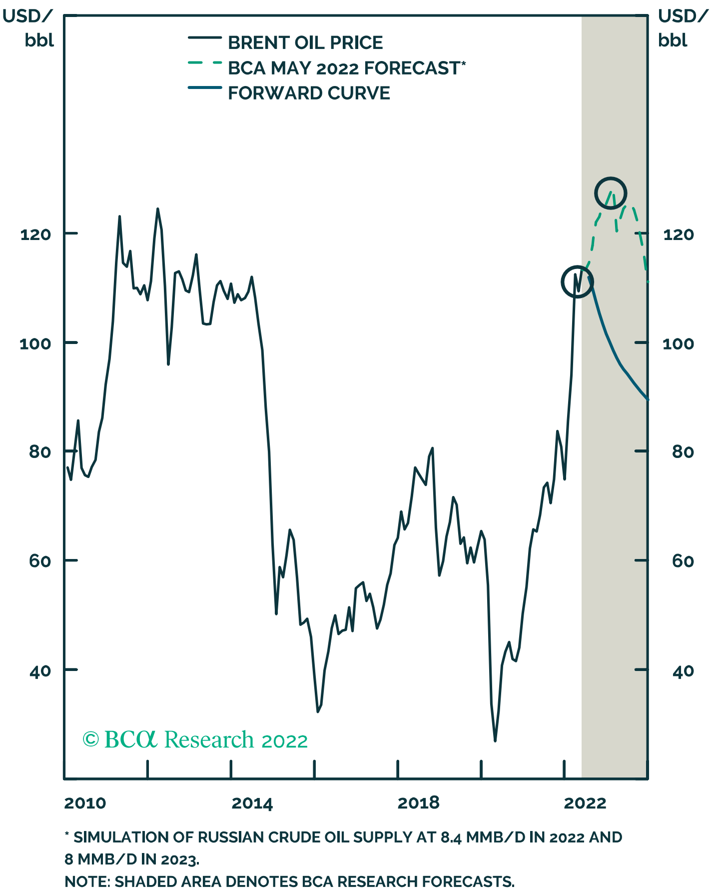


Figure 4 – Brent oil price growth

A complete cut-off of natural gas exports would be disastrous for both Russia and many European countries. The Russian economy would be crippled by a huge reduction in its current account surplus, and it would trigger a wave of recessions across Europe as gas is rationed and energy prices skyrocket. The impact of this on European voters is challenging to determine – it may erode their willingness to support Ukraine, or strengthen their resolve to oppose Russian aggression.

A much more likely scenario is Russia throttling natural gas exports to European countries, artificially increasing prices and limiting Europe's ability to build sufficient energy stockpiles for the coming winter. While less destabilising than a complete cut-off, this would meaningfully increase inflation across Europe and erode investment confidence.

How Russia will weaponize their gas reserves unfortunately remains a mystery, but Putin's actions have been more aggressive and volatile than many expected. Our base case is a reduction in exports from Russia, but not a complete cut-off in 2022. This will cause a slowdown across Europe, but will most likely avoid an incapacitating recession.

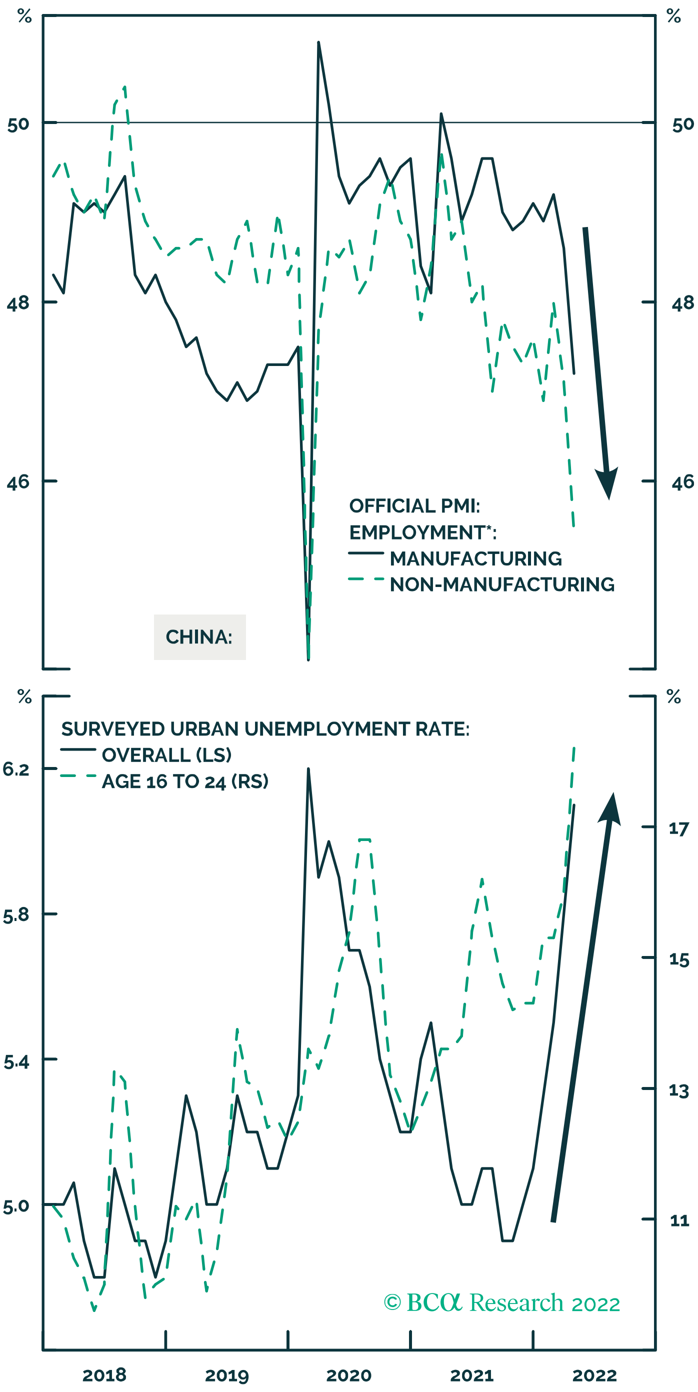
China – The state will provide

China is one of the core pillars of global demand, so any change in consumption causes ripple effects across the globe. Due to the increased infectiousness and transmissibility of the Omicron variant, China's zero-tolerance Covid-19 policy has failed to contain the disease and further outbreaks are expected across the country.

Despite official statements, we believe Chinese policymakers are aware of the direness of the situation, but are hamstrung by the consequences of removing the policy. Recent studies suggest that removing the policy could result in intensive care demand 16 times higher than capacity, as well as over 1.5 million excess deaths (the US has only experienced 1 million deaths over the past 2 years).

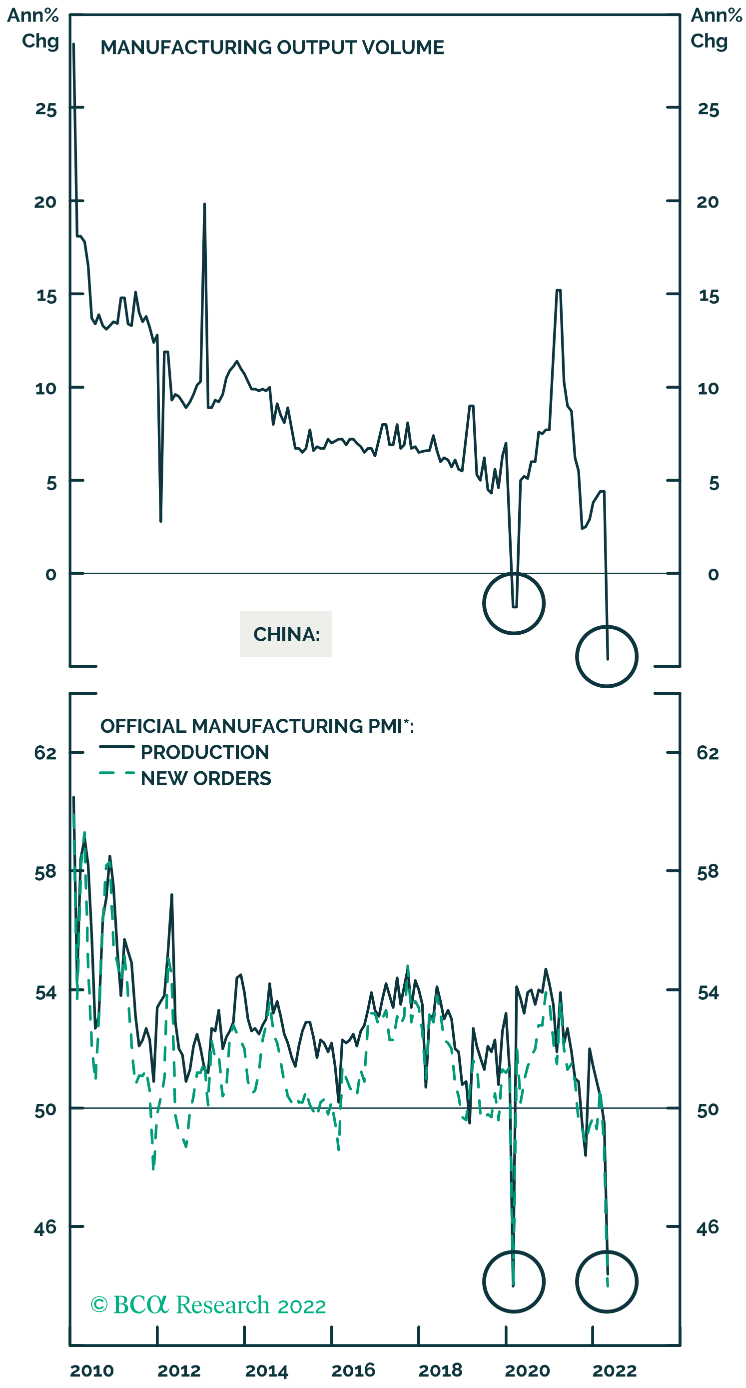
However, the consequences of maintaining the policy will have a severe impact on the Chinese economy, which is likely also an important constraint for policymakers. The Chinese labour market and industrial sector have already fallen significantly over the past several months, deteriorating at a rate that will be unsustainable for the Chinese Communist Party ("CCP") for much longer – see Figure 5 on the following page.

This would not be disastrous if the decrease in activity was short-lived, but this no longer appears to be the case. Cases in the Yangtze region and Shanghai may be decreasing, allowing the areas to open up for business, but it is incredibly likely that a future outbreak will occur in either region or another area of the country. If the government does not ease its zero-tolerance policy, additional fiscal and monetary aid is expected. This may take the form of traditional government spending, or new US-style income supportive policies that occurred in developed countries at the beginning of the pandemic. If



* SOURCE: NBS; SERIES TRUNCATED AT 44%.

Figure 5 A – Chinese PMI and urban unemployment



* SOURCE: NBS; SERIES TRUNCATED AT 44.

Figure 5 B – Chinese manufacturing output and PMI

the CCP adopts a income supportive policy, hopefully they will learn from other country's mistakes. These policies in the US resulted in a large increase in aggregate disposable income, which was spent on speculative activities rather than supportive economic ones. Regardless of the manner in which they provide stimulus, the Chinese economy will be unable to maintain its course without some significant investment should the CCP continue on the path of zero-tolerance. We believe that additional support will be announced over the coming weeks and months to aid Chinese consumers and businesses. Should this not materialise, we expect a reduction in global activity and a general decline in equity markets.

Investment takeaways

Unfortunately, 2022 is proving to be as trying of a year as 2020 and 2021 were for both global economies and equity markets. While investors face many risks for the remainder of 2022, these risks are thankfully known and relatively quantifiable.

The US has managed to stave off a recession that pundits have been predicting. While it may teeter close to the edge of recessionary territory for the next year or two, we still do not believe the US will enter into a prolonged recessionary environment. Inflation signals are indicating a peak, and interest rate increases should soon follow suit. Households are still sitting on excess cash gained during the pandemic, which is primed to flow into the underutilised services sector. The world's largest economy should continue to chug along, albeit slower than in the past, for at least another year or two.

No one predicted the extent and suddenness of Russia's invasion of Ukraine, or that once it began Ukraine would be able to stave off the Red Army for so long. Now, three months later the invasion is still ongoing, and has pulled its Western neighbours into the fray. Years of underinvestment into local energy production and a move away from nuclear energy generation has caused many European nations to be dependent on Russia's energy supply, which they know wield as a weapon against interference. Sudden and complete embargos from either side is unlikely, as it would cripple both economies and result in far reaching political upheaval. We believe

that further partial embargos may be put in place, or Russia may throttle supply – either will likely result in increased energy prices, further inflation, and decreased desire to inflate tensions further.

China had managed one of the most effective Covid-19 policies in the world, but the cracks started to show in early March 2022. The zero-tolerance policy has been proven to be ineffective and containing the disease, and is not economically sustainable for an extended period of time. The CCP will need to adjust course on how they manage the disease, or institute massive stimulus efforts to support both their populace and struggling businesses. The failure to do one or both will likely result in the world's second largest economy entering into a recession.

Should the above risk factors follow our expected path, global equities should experience a recovery over the course of the year. Failure for any of the above mentioned scenarios to materialise will probably result in a prolonged equity bear market. Investors should remain vigilant and invest in good quality, undervalued businesses.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 837,35	-3,1%	0,4%	-3,3%
Brent Crude	122,84	12,3%	57,9%	74,9%
USDZAR	15,6405	-0,9%	-1,9%	13,7%
EURZAR	16,7767	0,6%	-7,5%	-0,1%
GBPZAR	19,7178	-0,8%	-8,6%	1,3%
JSE All Share TRI	11 937,02	-0,4%	-0,3%	9,5%
JSE Resources TRI	6 027,72	-0,3%	11,4%	20,6%
JSE Industrials TRI	16 176,71	-2,4%	-17,4%	-9,7%
JSE Financials TRI	11 283,89	4,3%	17,3%	30,5%
JSE Listed Property TRI	1 639,65	0,0%	-2,6%	14,6%
S&P 500	4 132,15	0,0%	-13,3%	-1,7%
Euro STOXX 50	8 535,36	0,9%	-10,1%	-4,5%
FTSE 100	7 666,61	1,1%	4,8%	11,5%
Nikkei 225	46 256,80	1,6%	-4,4%	-3,5%
Hang Seng	66 336,91	2,2%	-7,6%	-25,5%

Source: Bloomberg, as at 31 May 2022

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