EFFICIENT GROUP

ECONOMIC COMMENTARY

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WHERE DOES THAT LEAVE US?

Markets in the United States (US) were shocked when Federal Reserve (Fed) Chair, Jerome Powell, gave his annual address at the Central Bank Summit in Jackson Hole. In the past, this event has been used to make important announcements about central bank policy. In the early 2000s, US central bankers used the event to announce that they would start cutting interest rates to support economic activity, which finally led to the 2008/2009 global financial crisis. A few years later, US central bankers used the event to announce quantitative easing, which supported the recovery, overstimulated global demand, and led to rapidly rising equity prices. Now, more than a decade later, Powell took a firm stand in favour of further interest rate increases in the US "until the job is done" on inflation.

US markets tumbled after the announcement, with the S&P 500 falling as much as 3.4% and the technology-heavy Nasdaq Composite sliding 3.9%. It seems that previous expectations that the Fed might slow down the pace of interest rate increases, or that they were even considering when to start cutting interest rates, were premature. Some analysts even interpreted Powell's recent message to mean that the US will experience an unpleasant period but that it is needed. By this, they mean that a further economic slowdown and potential market correction is needed to cool off the economy and thereby contain inflation.

Where does that leave us? Well, I think it was a bit silly to believe that the brief slump and the partial recovery that we saw in global markets this year was all that there would be. The pain caused by an interest rate hiking cycle is usually a bit more severe. Although the US entered a technical recession, their economy is still far away from the type of correction that is needed to reduce inflated demand, which was caused by more than a decade of loose monetary policy. For this reason, the Fed is targeting unemployment closer to 4.5%, which they believe is one of the measures that will indicate that inflated demand has, in fact, subsided. We can, therefore, easily see markets in the developed world correct by another 10%, maybe even more, as central banks continue to press for higher interest rates.

But does this mean that the US will enter a long-term cycle of stagnation, where economic growth remains under pressure for more than two years and where markets persistently underperform? Probably not. However, the European Union (EU) might fall into a long-term stagnation because the appropriate response to combat high inflation requires policy flexibility, where each country must be considered individually. That being said, the European Central Bank's main policy tool is an EU-wide interest rate that lacks flexibility. Increasing interest rates is the fastest way to tame demand-driven inflation, but while Germany will be able to live with higher interest rates, Greece and Italy, among others, will, most likely, enter a persistent slump. Relatively speaking, the US will, therefore, most likely, be in a better position than the EU, which is why the dollar should remain range-bound around parity against the euro in the immediate future. Once the EU has caught up in their rate-hiking cycle, and if they can get the economic block out of recession territory, the dollar might start to depreciate markedly against the euro.

In South Africa, because the balance of payments is coming under pressure, while the economy struggles under the burden of bad policy, a deteriorating Eskom, and silly demands by trade unions, it will be difficult to see the rand return to its long-term natural range of between R14.50 and R15.00. A more appropriate rate which long-term investors should, therefore, consider is R16.00 against the US dollar. We still maintain that the volatility that we are experiencing in markets creates good long-term buying opportunities and we warn against being too conservative. Corrections do not come by very often and they should, therefore, be seen as buying opportunities, not as exit opportunities. Furthermore, when deciding to invest, both the rand and the level of global markets should be considered. Both can be used simultaneously to find appropriate entry levels.