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Capricorn Asset Management
a member of Capricorn Group

Economic Outlook for 2022

Inflation versus Central Banks. That is the key theme playing out in financial markets. The Fed (Federal Reserve, the monetary policy authority of the USA) and the SARB MPC (Monetary Policy Committee), as well as many other Central Banks, have started the process of exiting from the extraordinary measures taken during the Covid-19 crisis. This means that policy determined interest rates will be rising through the course of 2022 from their historically low levels.

This is largely due to an inflationary shock. Recent inflation in the USA exceeded our worse expectations. Consumer inflation shot up to 7.0% and producer inflation to 9.7%. The big inflation impulse globally came from surging oil and petroleum prices. The Bloomberg petroleum index jumped by 63% in 2021. However, in the USA inflation has broadened beyond just energy. This resulted in a record low real Fed Funds Rate of -6.8%, a situation which cannot be tolerated for long in a buoyant economy that is close to full employment. The Fed is likely to raise its target rate to 1.0% by year-end from the current 0.25%.

Inflation rates in Namibia (at 4.5%) and the RSA (at 5.9%) are also on a rising trend. Both rates seem set to breach or come close to the current upper band of 6.0% of the SARB targeting framework during the year before drifting down again. We think the SARB will lift its Repo Rate by another 0.50bp to 4.5% by year end. The BoN is also likely to increase its Repo Rate and, playing “catch-up”, will probably hike by a total of 1% to 4.75%. This means that the Prime Rate in Namibia is likely to rise from 7.50%, the lowest its ever been, to 8.50% by year-end.

There is enough momentum in the global economy to achieve growth of 4% to 5% in 2022. However, it still constitutes a slowdown from the sharp bounce in 2021, which followed the Covid-19 driven contraction in 2020. The USA is expected to grow by 4.5%+ (down from 5.2%) in 2022, China by 5.5% (down from 8.0%), the RSA by 2.0% (down from 5.0%) and Namibia by 3%+ (up from 1.0%). The latter is simply predicated on some degree of normalisation in 2022, given that the Omicron wave is largely over.

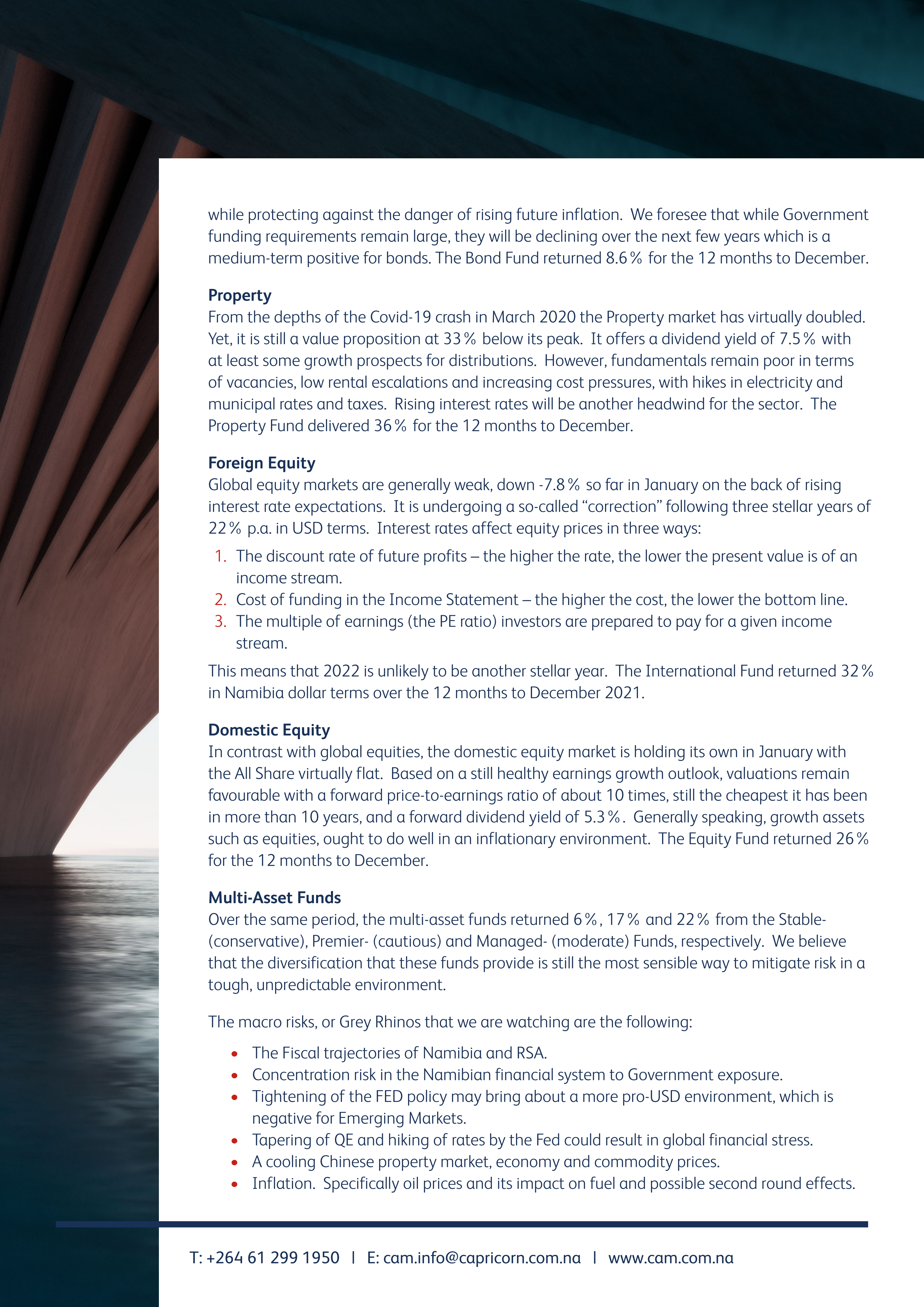
The slowdown in China could be worse, given the troubles in its property market and the severe regulatory measures affecting many sectors. Therefore, commodity prices are likely to peak and flatten out, albeit at historically high levels. This will constitute a fading tailwind for the currency. This means that we foresee the exchange rate to the US dollar at 16.50 and 17.50 by year end 2022 and 2023, respectively. This rate of depreciation is unlikely to trigger more aggressive hikes by the SARB.

Money Market

The prospect of rising short-term rates lifts the expected return from the money market. After all was said and done, the SARB started to raise interest rates in November and hiked again in January to 4.0%. It appears that the normalisation argument won out over most other considerations. This means that money market returns going forward could improve somewhat, but not by much, given that rates already factor in a gradual rise. The 5% to 6% ballpark for expected returns is likely to prevail for the next year or so.

Bonds

Over the past two months the RSA generic ten-year Government bond yield declined from 10% to 9.35%, which would have had a positive effect on capital values. We think that the yield is still attractive and compensates for fluctuations in market values. Namibian inflation linked bonds’ pricing are also still very enticing, delivering a substantial real return,



while protecting against the danger of rising future inflation. We foresee that while Government funding requirements remain large, they will be declining over the next few years which is a medium-term positive for bonds. The Bond Fund returned 8.6% for the 12 months to December.

Property

From the depths of the Covid-19 crash in March 2020 the Property market has virtually doubled. Yet, it is still a value proposition at 33% below its peak. It offers a dividend yield of 7.5% with at least some growth prospects for distributions. However, fundamentals remain poor in terms of vacancies, low rental escalations and increasing cost pressures, with hikes in electricity and municipal rates and taxes. Rising interest rates will be another headwind for the sector. The Property Fund delivered 36% for the 12 months to December.

Foreign Equity

Global equity markets are generally weak, down -7.8% so far in January on the back of rising interest rate expectations. It is undergoing a so-called "correction" following three stellar years of 22% p.a. in USD terms. Interest rates affect equity prices in three ways:

1. The discount rate of future profits – the higher the rate, the lower the present value is of an income stream.
2. Cost of funding in the Income Statement – the higher the cost, the lower the bottom line.
3. The multiple of earnings (the PE ratio) investors are prepared to pay for a given income stream.

This means that 2022 is unlikely to be another stellar year. The International Fund returned 32% in Namibia dollar terms over the 12 months to December 2021.

Domestic Equity

In contrast with global equities, the domestic equity market is holding its own in January with the All Share virtually flat. Based on a still healthy earnings growth outlook, valuations remain favourable with a forward price-to-earnings ratio of about 10 times, still the cheapest it has been in more than 10 years, and a forward dividend yield of 5.3%. Generally speaking, growth assets such as equities, ought to do well in an inflationary environment. The Equity Fund returned 26% for the 12 months to December.

Multi-Asset Funds

Over the same period, the multi-asset funds returned 6%, 17% and 22% from the Stable- (conservative), Premier- (cautious) and Managed- (moderate) Funds, respectively. We believe that the diversification that these funds provide is still the most sensible way to mitigate risk in a tough, unpredictable environment.

The macro risks, or Grey Rhinos that we are watching are the following:

- The Fiscal trajectories of Namibia and RSA.
- Concentration risk in the Namibian financial system to Government exposure.
- Tightening of the FED policy may bring about a more pro-USD environment, which is negative for Emerging Markets.
- Tapering of QE and hiking of rates by the Fed could result in global financial stress.
- A cooling Chinese property market, economy and commodity prices.
- Inflation. Specifically oil prices and its impact on fuel and possible second round effects.

- A negative pincer effect on corporate margins due to the differential between PPI and CPI inflation.
- A knee-jerk tightening by Central Banks, including SARB and BoN, due to cost push inflation.
- Derailment of the recovery by lockdowns due to Covid-19 flare-ups. Namibian economy does not grow.
- Fiscal overkill by the USA. Huge spending plans leading to an overheating economy.
- Such an overheating could play out in inflation as well as the residential property markets.
- Climate related regulations making doing business more difficult and energy even scarcer.
- Domestic politics and global geopolitical risk. ANC policy conference (June) and its elections (December).

As we have stated in the past, over time, different risks will come to the fore and dominate headlines and then fade again to the background. All the while, we must guard against information overload, sensibly distinguish between noise and fundamentals, and focus on the likely impact on asset values as such, where fundamentals usually win out.