MERGENCE
INVESTMENT MANAGERS

Macro and Multi-Asset

May 2023

Currently the dominant debate in global macro is whether the global economy faces a hard or soft landing. 2022 say high levels of inflation and global central banks have tightened monetary policy aggressively in response. Will this cause global economic growth and company earnings to crash land later this year, or can inflation moderate without a sharp recession and large job losses? In this piece we give our definitions of the hard vs soft landing scenarios, try to estimate how financial markets may react in each and then give some of the arguments for each outcome.

Current Views

Underweight Risk Assets	Overweight SA Equity vs Global Equity	Overweight SA Fixed Income	Overweight Global Credit vs Equity	Overweight USD Cash

Asset Allocation views

Asset Class	Valuation based 3-Year Forecast Return	Underweight	Neutral	Overweight
SA Equity	17%		Neutral	
SA Property	18%		Neutral	
SA Fixed Bonds	12%			Overweight
SA Inflation-Linked Bonds	11%		Neutral	
Emerging Market Equity	6%	Underweight		
Developed Market Equity	1%	Underweight		
Global Property	6%	Underweight		
Emerging Market Sov. Bonds	5%		Neutral	
Developed Market Sov. Bonds	0%			Overweight
Global Corporate Bonds	2%		Neutral	
Global Inflation Linked Bonds	2%	Underweight		
Global High Yield Bonds	5%		Neutral	
Offshore Cash	1%			Overweight

Source: Mergence Calculation. All forecasts in ZAR. Current asset allocation views are relative to our Strategic Asset Allocation.

Landing Softly or Hardly Landing

"There is an art, it says, or rather, a knack to flying. The knack lies in learning how to throw yourself at the ground and miss. … Clearly, it is this second part, the missing, which presents the difficulties."
— **Douglas Adams, Life, the Universe and Everything**

Currently the key question in global macro thinking is if the global economy is heading for a hard or soft landing. In this piece we give our definition of these two scenarios, how we could expect asset classes and financial markets to perform in each and summarise some of the arguments for each outcome.

Definitions

We would define a hard landing as a scenario where the global economy enters a typical disinflationary recession. Growth falls and developed economies enter recessions. The US labour market weaken and CPI in the US falls below 2%, eventually causing the Federal Reserve to cut rates.

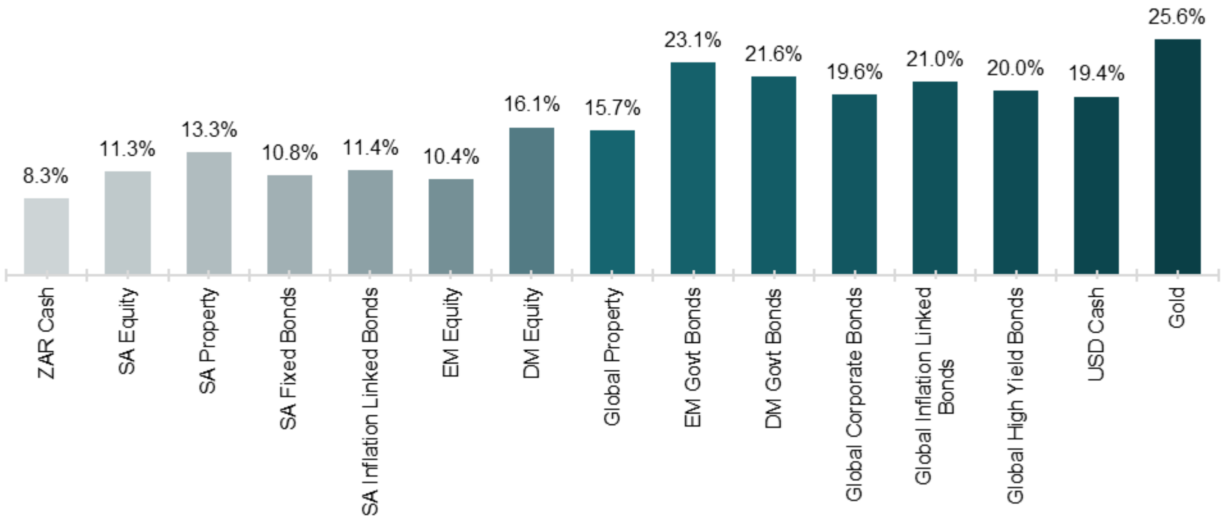
In a soft landing, inflation slows towards the Fed's 2% target, but the US consumer remains resilient. The Fed is able to stop hiking and start to guide towards easing policy and Chinese economic growth is strong. Commodity prices remain supported by tight supply fundamentals and Chinese growth.

Expected performance

- ### A hard landing - how could financial markets perform?

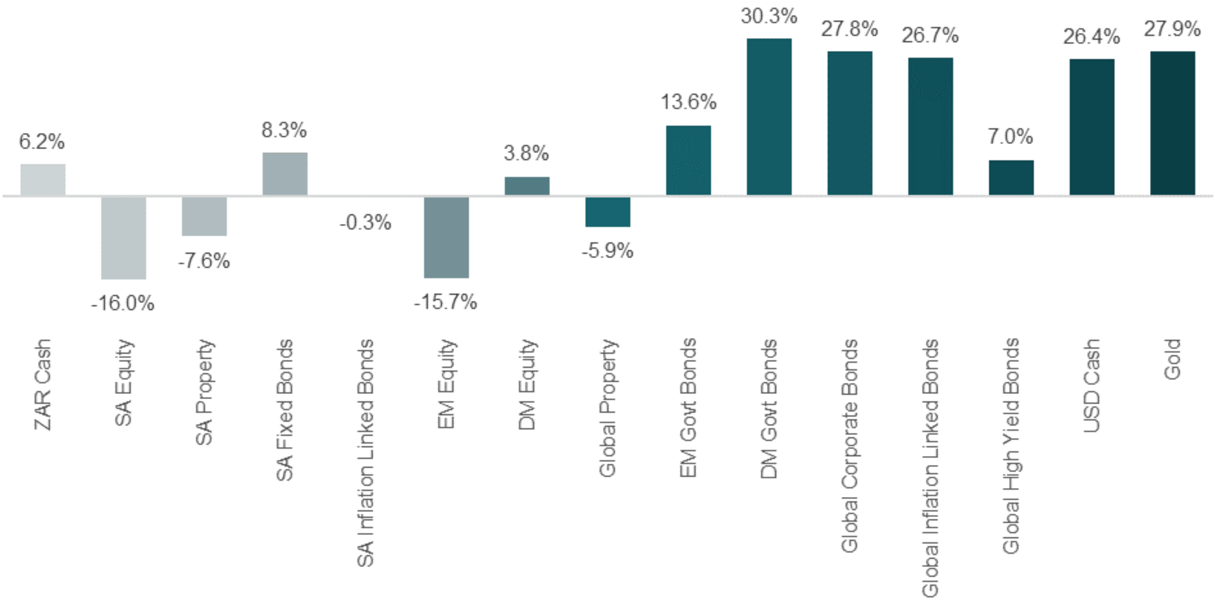
  We would expect a hard landing to be similar to previous contraction periods of slowing growth and falling inflation rates. This would be characterised by a broad risk-off sentiment, with risk assets falling and emerging market assets underperforming. Chart 1 below shows historic average annualised asset class performance during periods of a falling global growth cycle.

Chart 1: Average Asset Class Annual Returns - Falling Growth Cycle



If we isolate only the periods that saw a de-linking growth cycle and a falling inflation cycle, the picture looks even more extreme, as shown in Chart 2 below.

Chart 2: Average Asset Class Annual Returns - Contraction Regime



In both of these scenarios the historic tendency has been for both offshore and fixed income asset classes to outperform.

The counter to this analysis is that while contraction periods have historically led to extreme return outcomes, they have occurred quite infrequently and therefore we should be sanguine about our ability to predict such an outcome.

- ### A soft landing - how could financial markets perform?

A soft landing scenario could see emerging market assets outperform, even as risk assets in developed markets de-rate. It is difficult to isolate exact historic analogies for a soft landing regime, but we would expect risk asset performance to be more positive than in the hard landing scenario, with emerging market assets, emerging market currencies and commodities doing better than a typical recessionary regime.

Arguments

- ### What are the arguments for a hard landing?

The main argument for a hard landing is the extent of monetary tightening that has occurred over the past 24 months. The increase in the Fed funds rate is currently the sharpest in the past 35 years, as shown in Chart 3 below.

Chart 3: 1 Year Change in the Fed Funds Rate

Over the past 12 months, over 80% of global central banks have been tightening policy (see Chart 4 below). Global central bankers have thrown all they can at inflation. Hoping for a soft landing from here seems a little like throwing oneself at the ground but hoping to miss in an attempt to fly.

Chart 4: Percentage of global central banks raising rates

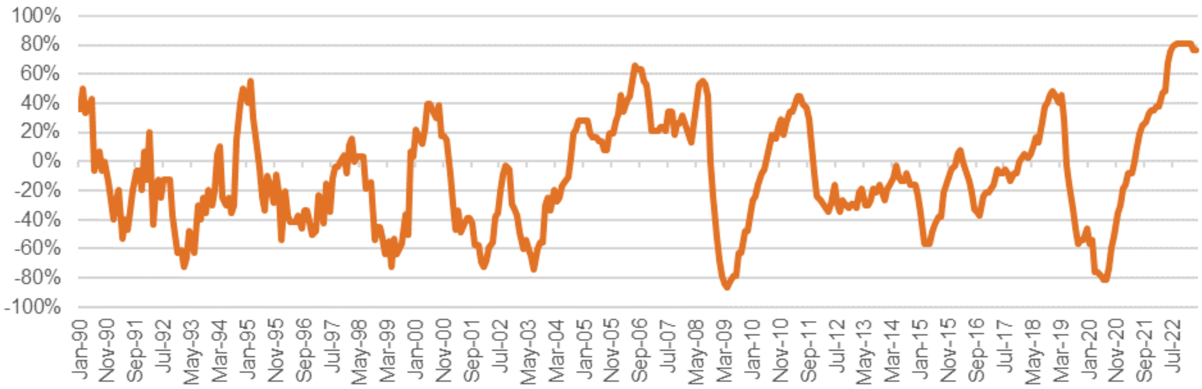
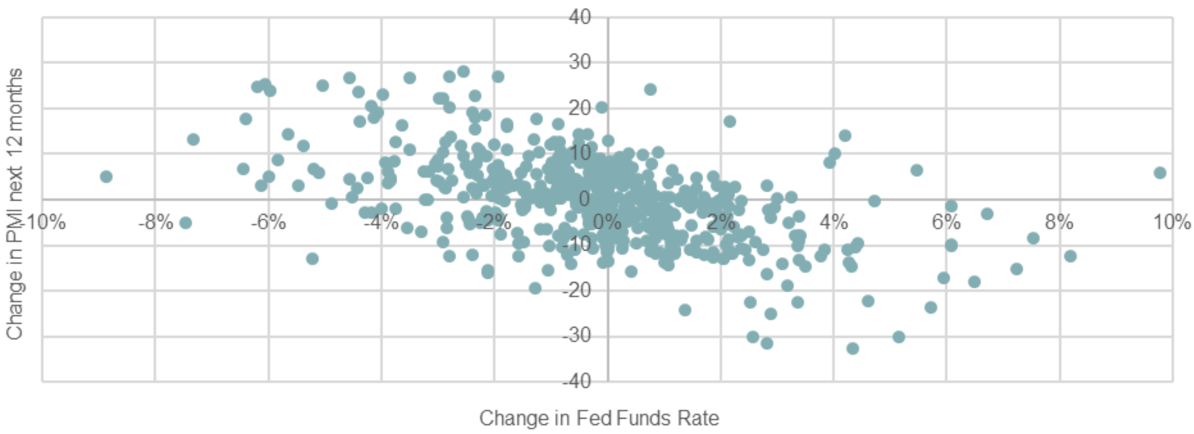


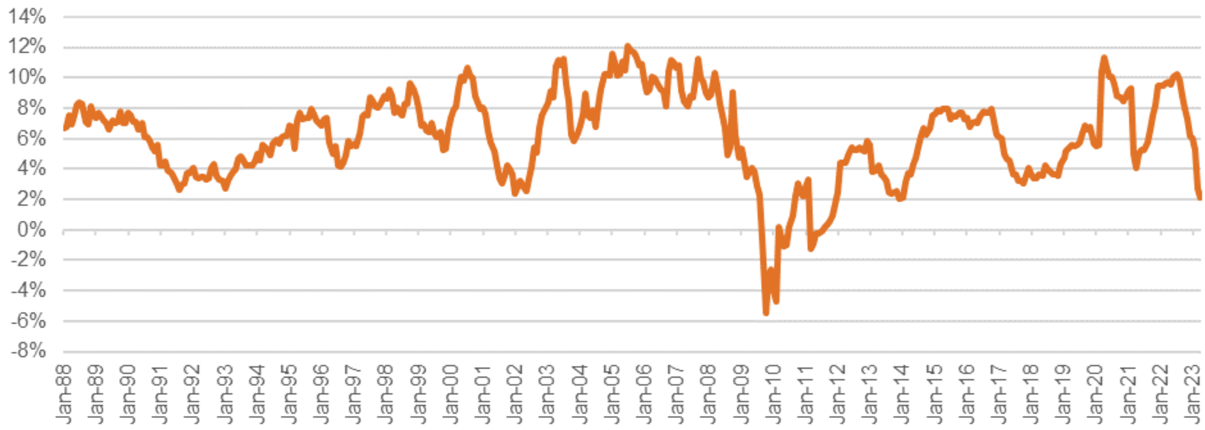
Chart 5 below shows the relationship between rate hikes and the subsequent evolution of economic growth as measured by the Institute for Supply Management ("ISM") services and Purchasing Managers Index ("PMI") suggesting further downside to US PMIs.

Chart 5: Changes In PMI vs Fed Funds Rate



To exacerbate this situation, the collapse of Silicon Valley bank and associated deposit flight from regional US banks during Q1 2023 has led to a contraction in bank lending in the US, as shown in Chart 6.

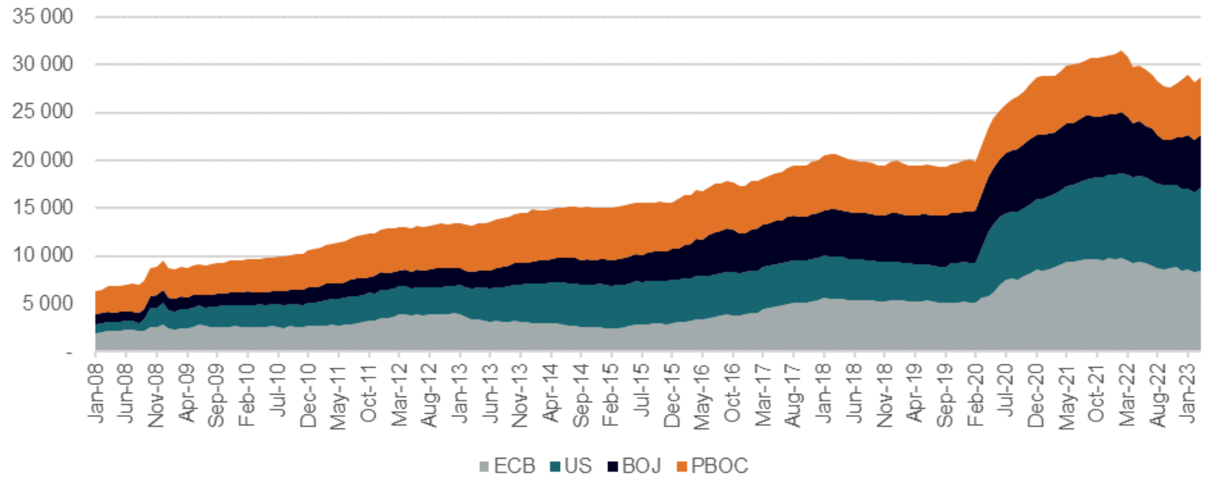
Chart 6: US Total Bank Credit 12 Month Change



The arguments for a soft landing rely on continued stimulus from global central banks, a strong US consumer and robust Chinese economic growth.

After contracting in 2022 driven by US quantitative tightening, global central bank balance sheets have started to expand again. This is shown in Chart 7 below.

Chart 7: Big 4 Central Bank Balance Sheets



In the mid-2000s, there was much focus on the economic decoupling of the West and the East, as the US housing market started to slow while the Chinese economy continued to grow quickly driven by high fixed capital investment, stimulating a commodity super cycle. Again, there is hope of an economic decoupling between the slowing US and the Chinese economy which still has some of the tailwinds from its 2022 re-opening post COVID lockdowns and a government that is more willing to stimulate the country's economy.

Chart 8: China Credit Impulse

Also supportive of the US economy is the resilience of the US labour market. Over the past two years, the US labour market has been at its strongest level for the past two decades as measured by the number of jobs available per unemployed person. While the market has started to weaken, it is still historically very strong and remains supportive of the US consumer.

Conclusion

In conclusion we think that the outlook for the US economy looks challenging and historically equity markets, emerging market currencies such as the Rand, and commodities have very seldom remained unscathed during a global recession. In addition, while South African assets have priced in a lot of pessimism, we fear that things may get worse before they get better as we head into a tough winter for our local electricity supply.

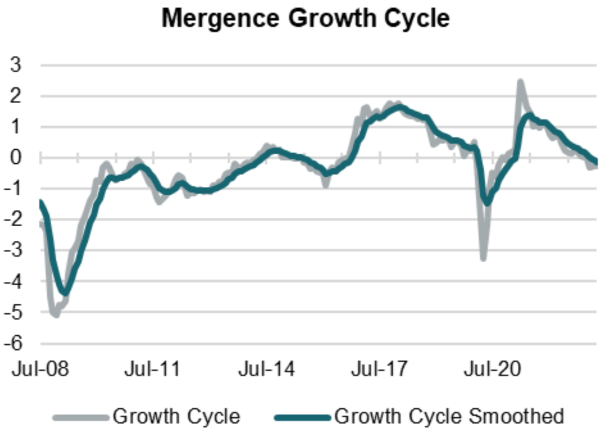
Having said that, the arguments above as well as the longer-term tight supply demand outlook for global commodities and a more attractive valuation backdrop do suggest that emerging market and commodity-related assets may perform better in this downturn than they have previously.

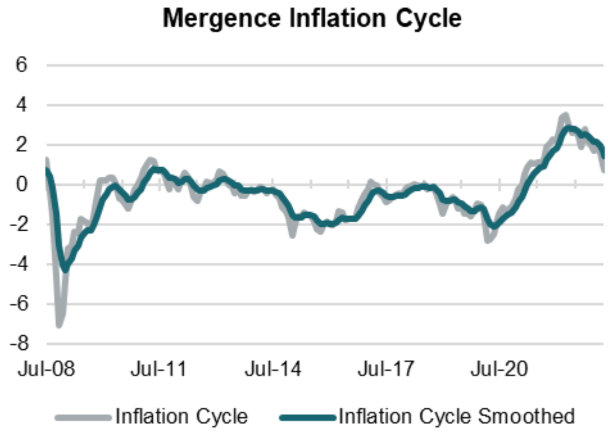
We remain cautiously positioned but within our overall defensive portfolio structure, we do retain exposure to the cheaper parts of the market, preferring emerging market exposure over developed market exposure on a relative basis.

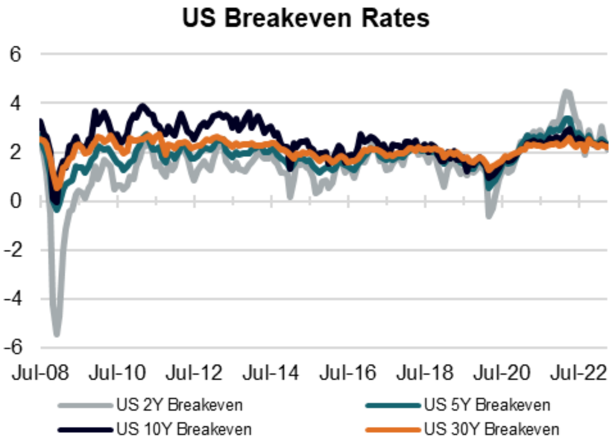
Key Indicator forecasts

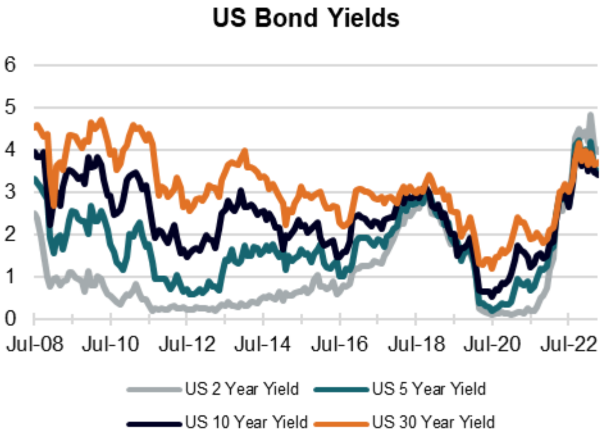
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	18.3	15.4	16.1	16.9
EURZAR	20.2	17.7	18.8	19.9
GBPZAR	22.9	20.3	21.2	22.2
SA 10 Year Yield	10.1%	9.9%	9.0%	9.0%
US 10 Year Yield	3.4%	3.4%	3.1%	3.2%
SA Inflation	5.7%	4.9%	4.9%	5.0%
US Inflation	3.5%	2.7%	2.4%	2.5%
SA Repo Rate	7.8%	7.3%	7.0%	7.0%
US Fed Funds Rate	4.8%	4.4%	3.0%	2.5%

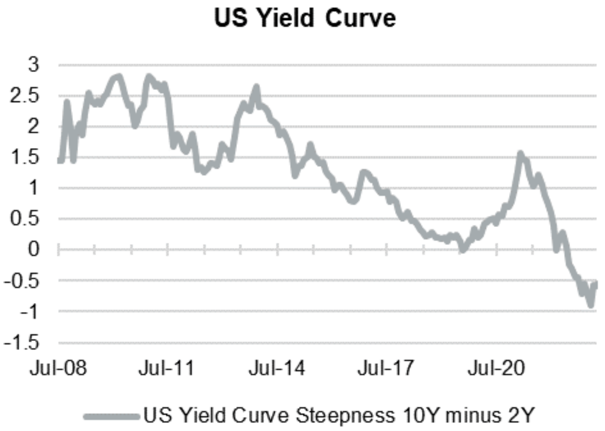
Key Macro charts

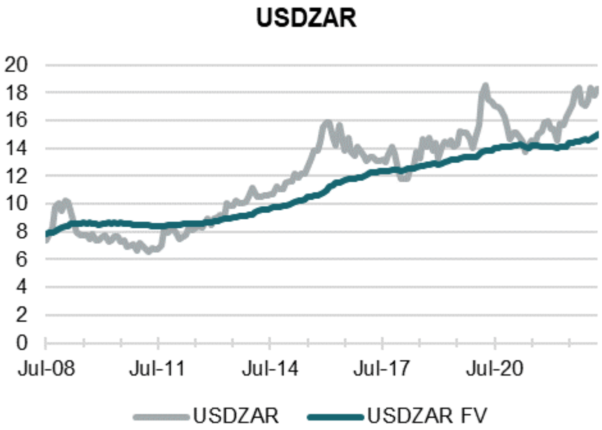




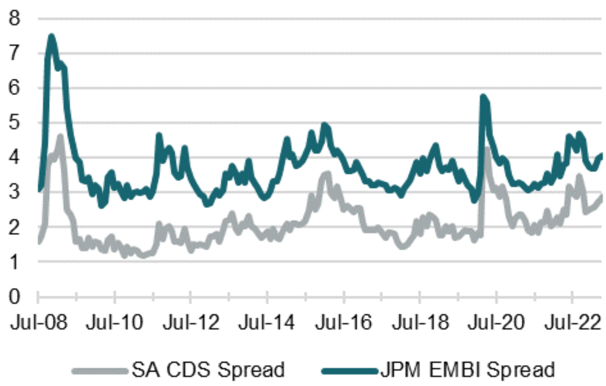




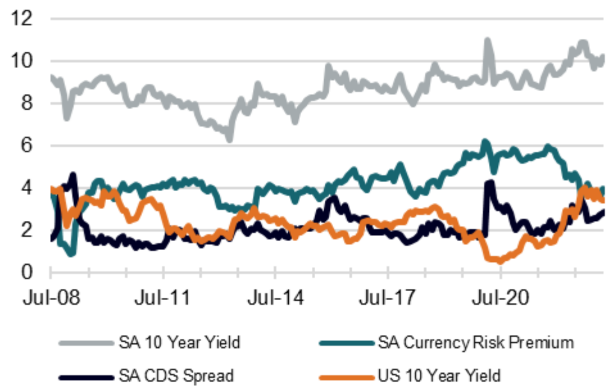




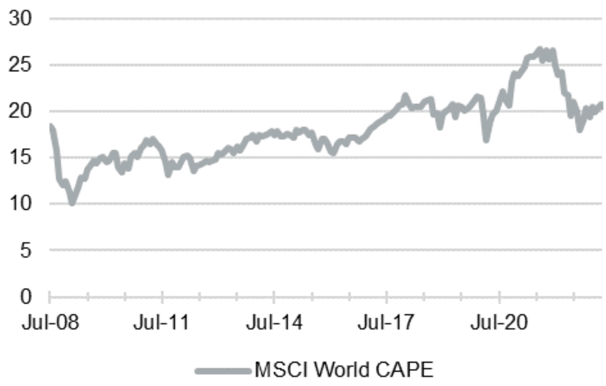
SA CDS



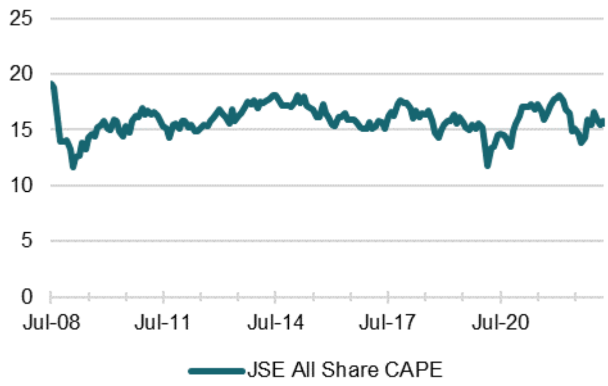
SA Yield Breakdown



MSCI World CAPE

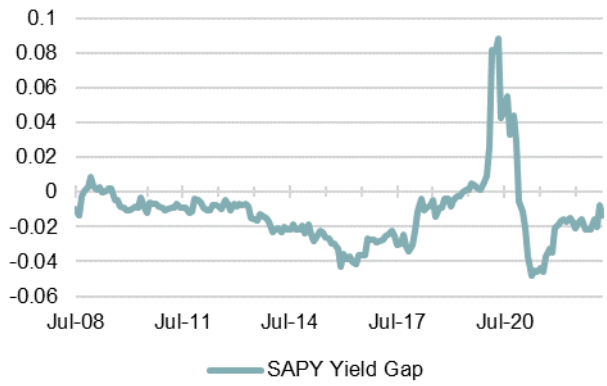


JSE All Share CAPE



JSAPY Price to Book

SAPY Yield GAP



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