INTEGRAL
Asset Management

The Outlook

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The five big forces.

An increasing number of commentators have highlighted individual areas of market concern, yet US investors see no impending global inflection point. The recent yen carry-trade unwind was a short-lived test where the S&P 500 fell 8.5%, only to recover to within a whisker of its all-time high. A classic herd approach of safety in numbers. The difference between humans and animals, however, is that by staying close, animals can detect and respond more quickly to approaching danger. Humans are not as adept.

The US market concerns are succinctly summarised as the "Five big forces" by Ray Dalio, ex-Bridgewater Capital (to this list we would add demographics):

- ✓ Economic force – debt, deficits, inflation, and interest rates,
- ✓ Internal order force – widening gaps (income, wealth, etc), immigration, upcoming elections,
- ✓ External world order force – heightened geopolitical tensions (US/China, G7/BRICS+ and de-dollarization, two wars, US/EU tariff war against China, cyber war, and drug cartels in South America),
- ✓ Force of nature – pandemics and extreme weather,
- ✓ Force of human inventiveness – the potential for AI to bring radical change in the coming years, including its use in wars.

Impending global inflection point?

Independently or simultaneously, these "forces'' are not likely to concern capital markets, especially the self-believing, entrepreneurial Americans. In our minds these forces have converged, and hence our greater attention to portfolio diversification which includes extra cash, gold, and shorter-term bonds.

As we head towards year-end there are two big areas of focus. Firstly, how geopolitics will unravel and the impact on global economies and trade. Secondly, the extent (25 or 50bps) of the rate cut on 18 September signalled by Fed chairman Powell at Jackson Hole, any further cuts, and whether the US economy soft-lands or slips into a recession.

Alpine Macro's latest thinking.

In its **Recession Fears, Market Indicators and Investment Bets** dated 26 August, Alpine Macro is firmly in the "no recession" camp. Alpine Macro believes that:

- ✓ *"The elevated inflation was caused by Covid-19 related supply chain disruptions,*
- ✓ *monetary tightening has not inflicted much damage on aggregate demand, at least not yet,*

- ✓ *No recession as the economy's ability to handle higher rates is stronger than before,*
- ✓ *US households have dramatically cut their debt loads since 2010,*
- ✓ *Household net worth has soared, and consumers are less inclined to save and more willing to spend,*
- ✓ *And labour productivity growth is rising".*

Nonetheless, Alpine Macro does advise that "*investors should be on alert to how the recession risk is evolving* and notes that *all previous recessions were preceded by financial crises that had threatened systemic stability*". But their bottom line is that "*there is certainly some growth weakness ahead, but no recession is called by any of the coincident or leading indicators*".

What about commodities?

Alpine Macro notes that "G*lobal manufacturing is not in a recession yet, but it is weak, which explains why commodities have also been soft".* Adding that *"China's economic downturn and sagging consumer demand are the big reasons behind the slump, and that the trend in China's monetary aggregate is ominous, conjuring up images of a slow implosion".*

Concerning oil, Alpine Macro were "*bullish on oil but not anymore. We are looking for opportunities to sell Brent contracts at $80 as a speculative trade".*

Powell's speech at Jackson Hole.

At last week's Jackson Hole gathering, Fed chair Powell said, "*There is good reason to think that the economy will get back to 2% inflation while maintaining a strong labour market*". Adding that, "*The time has come to adjust policy, and that the direction of travel is clear. The timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks*".

The market's reaction was whether a cut on 18 September will be 25 or 50 basis points, and how many thereafter.

It is easy to nod your head and agree with Alpine Macro and the Wall Street herd. But Dalio's Five Forces have converged, and this has implications for capital markets, interest rates and the dollar. Who will win between Trump and Harris is another imponderable. It seems that both candidates favour inflationary policies at a time when the US defence budget (+750 military bases in about 80 countries) is under increasing pressure, the Green Energy Transition needs funding, debt maturities and service costs are rising, welfare/entitlement programmes increased from $4.4tr in 2019 to $6.1tr in 2023, and more tariffs will only increase prices.

Debt, deficit, dollar and the yield curve slope.

Since the 1950s an inverted yield curve (see light blue line below) has predicted nine out of ten recessions. In anticipation of a Fed rate cut the 10-2-year yield gap has narrowed from -110bps in July to -3bps, almost wiping out the inversion.

No recession to date may be due to the massive stimulus (debt) that started at near zero rates. But no recession contrasts with the 2024 survey by GOBankingRates that reports that 13% of Americans do not currently bring in enough money to cover their bills, and 46% barely bring in enough to cover their bills.

The market is backing a 'goldilocks' scenario where a cut in the Fed funds rate is paired with falling inflation and a growing economy. For now, in the backseat, is the lower probability that the Fed is forced to cut rates because of a recession.

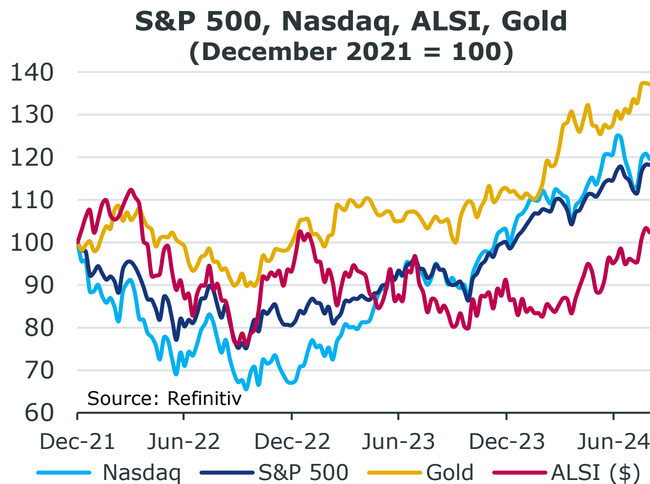
Our intuition is that the five forces together with changing demographics are disrupting global trade and politics, especially for China, and that US federal debt

can become more-risky as interest payments crowd-out other expenditure and the deficit increases.

US equities and the JSE ALSI in dollars.

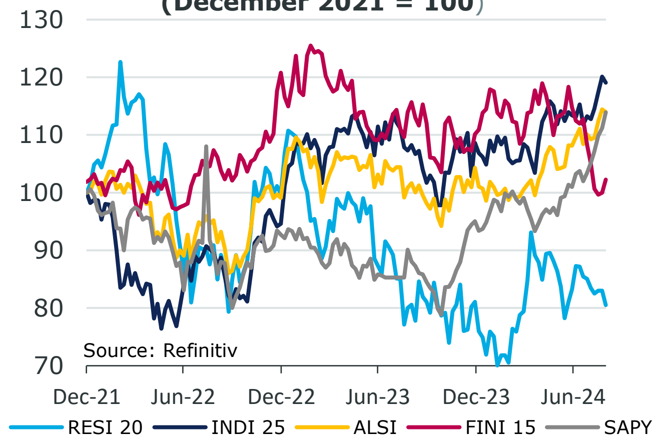
If you had blinked between 15 July and 22 August, you would have missed a burst of unprecedented volatility as the S&P 500 fell 8.5% and then rose by 8.7% to settle within a whisker of its all-time high of 5667.

Year-to-date (YTD), the S&P 500 and Nasdaq are up, respectively, 18.1% and 16%. But the big winner is gold, up 21.5%. The JSE ALSI is up 12.2% in dollars and 9.2% in rands. Of the sub-indices, Information Technology (+25.1%), Banks (+21.3%), and Communication Services (+20.8%), lead the YTD ranking. A potent performance given the higher rates and converging big five forces.



South Africa – GNU is on a knife-edge.

The stock market reacted positively to the announcement of the GNU, believing that the new political framework offers citizens hope of jobs and sustainable growth. But the reality is that although the ANC only won 40% of the national vote and 55.4% of the GNU, it blindsided the other parties and secured 70.7% of the National Executive (62.5% cabinet ministers and 76.7% of deputy ministerial positions). And, importantly, held on to the offices of President and Deputy President. Citizens and the business community now need to get behind the GNU and apply equal measures of support and pressure.



The SAPY (+19.9%) leads the JSE performance YTD, followed by the FINI 15 (+17.3%), the INDI 25 (+9.6%), the ALSI (+9.2%), and the RESI 20 (-0.7%). Despite the 'goldilocks' scenario sketched above, and top-end corporates doing well, we remain cognisant of the uplift in activities in the two wars, the US election uncertainty, and the risks associated with the convergent Five forces.

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