INTUITION

23 JUNE 2023

The next 12 months depend on just two variables

Over the past 2 weeks we have been touring the country, presenting our most recent Insight Seminar. It was a milestone to present in Cape Town for the first time, and those attendees must be given credit for braving the elements to attend. The topic of the seminar was the "Midyear Update" with the subtitle of "Are we there yet?" Any longsuffering parent will know that phrase only too well, but in this instance, it refers to two issues. Firstly, are we at the point of maximum pessimism in this country, especially about loadshedding? Secondly, are we nearing the peak in both global and local interest rates? In our opinion, the performance of markets over the next 12 months will hinge on these two factors.

Michael Porter

In our opinion, the outlook for markets over the next twelve months depends crucially on just two factors – the extent and trajectory of loadshedding and the trajectory of both US and our own interest rates. All the other issues (of which there are many) are just noise, in our view. Our recent Insight Seminar delved into these issues, which we repeat here for those unable to attend.

SPEED READ

- **There is a huge amount of activity in our electricity industry and the impact of past reforms is starting to manifest itself.**
- **Loadshedding has created a vicious cycle of weak growth, weak confidence, a weak rand, higher inflation and therefore higher interest rates.**
- **US inflation remains higher than authorities would like. But we feel that US rates are close to a peak and will fall in 2024. That is good news for SA and the Rand.**
- **A reduction in loadshedding coupled with peak US rates has the potential to reverse the vicious cycle and turn it into a virtuous one.**

Let me start with loadshedding, an emotive topic if ever there was one. At the outset, it is worth taking stock of the extent of loadshedding to appreciate just how much "the frog has been boiled" but also to give perspective to the potential should conditions turn. So far in 2023, we have only had a few days without any loadshedding at all. In 2022, we suffered from 158 days of loadshedding. That number has already been surpassed this year. Put another way, in May this year, we suffered an average of 7.5 hours of loadshedding per day, versus just 1 hour per day in May last year. That highlights the extent of the crisis.

The reasons behind loadshedding are well known. The Electricity Availability Factor (EAF) at Eskom's power stations fell from 70% two years ago to below 50% in April this year. Simultaneously, the percentage of the fleet subject to unplanned outages (breakdowns) has risen from 20% to 40%, with planned maintenance making up the difference.

As alluded to earlier, loadshedding has contributed towards a vicious cycle in SA. Simplistically, loadshedding has resulted in higher costs and margin pressure for companies across the economy, which in turn has led to weak economic growth and a loss of confidence from business leaders, citizens and investors. That in turn has led to a weaker currency and higher inflation, which has forced the Reserve Bank to increase interest rates to the highest level since 2008. That completes the cycle of higher costs and weaker growth. Not a pretty picture. So, whilst our inflation has started to moderate, it remains above the Reserve Bank's guideline and they have been explicit in their commentary that the Rand needs to strengthen before they will be comfortable that inflation has been tamed. Until that happens, our own interest rates will stay high and may even increase further.

In our opinion, loadshedding holds the key to a stronger currency. Any evidence that the trend in loadshedding is changing could lead to an improvement in the rand and hence a virtuous cycle. Over the past month we have had many interactions with electricity industry participants – from government ministers to private sector operators. Encouragingly, there is a flurry of activity. There is ample evidence that reforms undertaken over the past 18 months are starting to bear fruit, although we will be the first to acknowledge that much more needs to be done. One example is that new capacity registered with NERSA over the past 12 months stands at 4.1GW, 2.5GW of which were registered in the last 3 months alone. There is another 13GW of projects sitting in the Budget Quotation stage at Eskom - private sector projects that are in various stages of development. Projects need to pass through this process first before registering with NERSA, which tends to be one of the final steps. The pipeline is enormous, and growing!

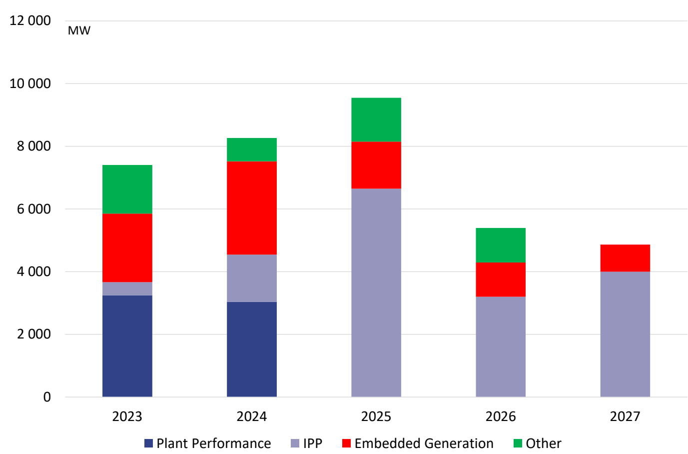
Over the next 5 years more than 30GW of capacity could be brought online in South Africa. What is encouraging is that very little of this relies on Eskom. Study the chart below. The dark blue bars represent capacity from Eskom – and this refers to bringing back into service units currently down for maintenance and repair, the bulk of which are the units at Kusile, Medupi and Koeberg. The green portions reflect other initiatives, such as reduced demand but also imports from the Southern African Power Pool. What is exciting is that the light blue and red bars reflect new capacity from the private sector – both large scale projects and embedded generation. This accounts for the bulk of new capacity and is not reliant on government money. To give credence to the momentum that is building in this country, between 10 – 15MW of new solar capacity is going live in this country every week as businesses and consumers invest in alternative supply.

The past 3 weeks have given us a glimpse of how quickly circumstances can change. Loadshedding has been drastically curtailed in June, thanks to a number of factors, including fewer breakdowns, better performance from wind and solar plants, a return to service of some existing units and slightly lower demand. The EAF is currently at 60%, the first time since August last year. That has coincided with the Rand strengthening from almost R20/$ to the current rate of R18.2/$ - an improvement of almost 10%. If this is maintained for the remainder of the month, we should experience another fall in fuel prices in July, further reducing inflationary and interest rate pressures. In our opinion, this illustrates perfectly the potential that could unfold if the trend in loadshedding could be reversed. We are almost certain that we will still experience loadshedding in 2024, but Stages 1-3 would be positive for the economy relative to the scale of loadshedding that we have had to endure this year, especially if we can see a further improvement into 2025.

Moving across to the US, inflation there is falling steadily. Headline inflation is now back to 4% - down from a peak of over 9% - so you might infer that interest rates there have peaked. In our opinion, that is too simplistic. As the chart below shows, headline inflation has declined steadily, but core inflation (excludes fuel and food) and services inflation (rents, medical etc) have yet to return to acceptable levels.

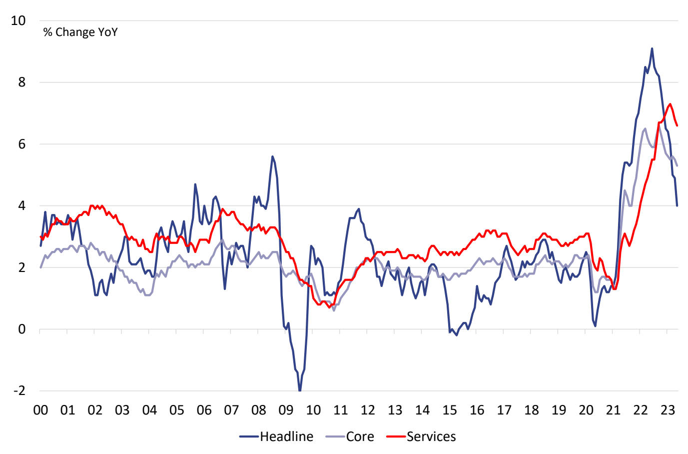
Nonetheless, there is some light at the end of the tunnel. House prices have stabilized in the US, which is an important leading indicator for rentals, and unemployment is rising, which suggests that the labour market is finally starting to soften. At the same time, US corporate profits are slowing sharply. Profits are now only growing at 4%

EXPECTED OPERATION DATE FOR NEW GENERATION



There is a growing pipeline of new projects coming onstream over the next 5-7 years that should fundamentally improve our electricity industry.

US INFLATION RATES



Whilst headline inflation has fallen sharply, core and services inflation has proved to be far more sticky, which explains why the Federal Reserve has continued to raise interest rates.

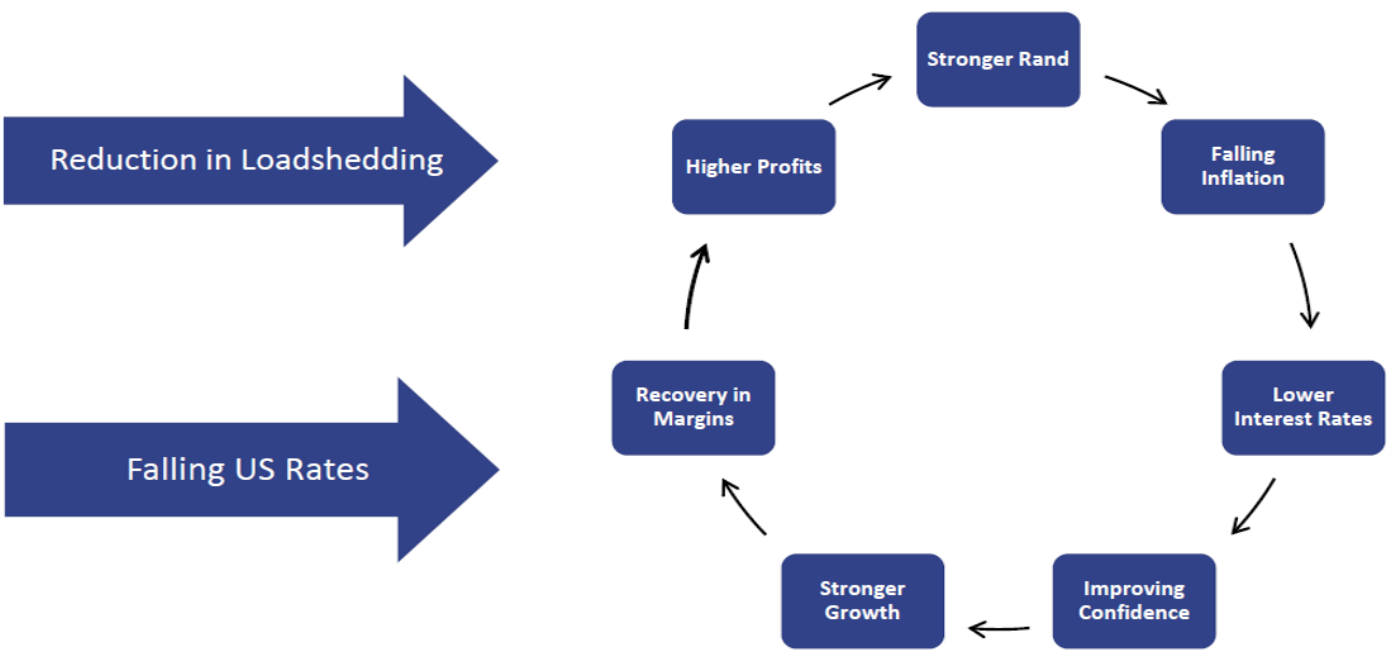
per annum – a clear indication that US businesses are feeling the pressure of weaker consumer spending and higher interest rates. Yet it is early days. The Federal Reserve will want to see more evidence that the economy is cooling before it considers its job done. Consequently, we believe that US interest rates will rise at least once more before stabilizing. Furthermore, we expect rates only to starting falling in Q1 2024 – not far away, but not this year as current forecasts suggest.

A peak in US interest rates is good news for SA as it implies a weaker US Dollar, declining US bond yields and stronger commodity prices. Combined, all of these should be supportive for the Rand (and other emerging market currencies.) This, combined with a more positive outlook on loadshedding, could turn the vicious cycle into a virtuous cycle. It is worth remembering that SA started to raise interest rates six months before the US. There is no reason why we cannot start our rate cutting cycle earlier too – provided the conditions start to fall into place.

Such a virtuous cycle will come at a time when SA assets are reflecting the pessimism so prevalent across our country. Local assets, whether it be equities or bonds, have seldom been cheaper. A virtuous cycle could imply solid multi-year double digit returns given the starting point. At the same time, US assets are not attractively priced. Market commentators often bemoan the concentration in the SA market and that the main indices are concentrated around just a handful of stocks. Yet the same is true in the US. At the time of writing, the S&P 500 Index had gained 12% for the year to date. 10 stocks – all tech giants – accounted for 11.6% of that return – as investors rushed to capitalize on the fervour around Artificial Intelligence. This performance masks the fact that the other 490 shares that comprise the S&P 500 have performed far more modestly – a reflection of the slowing economy. We believe it is worth being a little circumspect before following the herd who are advocating a rush out of SA and into the US.

In closing, the mood in SA is bleak, to say the least. But successful investing is all about looking forward, not backwards. Having endured the pain of Stage 6 Loadshedding, we must ask whether it can ever get better, because an improvement could be a sea-change for this country. Whilst we still think loadshedding will be a feature for some years to come, we do believe it is possible for the intensity thereof to reduce. That, coupled with a global tailwind of falling US rates, would materially improve the local outlook.

A VIRTUOUS CYCLE



The combination of an improvement in loadshedding and falling US interest rates could spark a rally in our currency, leading to the unfolding of a virtuous cycle.

Save the Date!

Our next Insight seminar will take place in September in Howick and Johannesburg. The topic will be announced in due course.

Harvard House is on Facebook

Harvard House is on YouTube

Topic:	TBC
Natal Midlands	
Date:	21st of September 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	19th of September 2023
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	n/a
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

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