



# OLD MUTUAL SUPERFUND

## INVESTMENT UPDATE

September 2022 | Q3



The most common financial literacy test was introduced by Lusardi and Mitchell in 2011. It asks three simple questions, testing one's understanding of compound interest, inflation and diversification benefits. Of the three questions, inflation is currently the indicator most closely watched by economists and investment professionals in 2022.

### What is inflation and how is it measured?

The most common measure for national inflation is the Consumer Price Index (CPI). CPI measures the overall change in prices of a representative basket of goods and services over time. Put simply, inflation is the rate of price changes over a given period. It is the price difference of a loaf of bread from R1.50 in 1990 to R14 in 2022; or the petrol price increase from 94c in 1990 to R25 per liter in 2022.

Inflation has a significant impact on us personally. It affects not only what we spend our money on, but also how much money we have left at the end of the month.



### What now?



Globally, as prices for commodities remain high, the energy and material sectors of economies benefit. By contrast, the big tech companies tend to suffer in environments of high interest rates as it reduces their future earnings estimates.

The US, in particular, which has equity markets tilted towards higher exposure to tech companies, has seen significant losses this year. Other markets such as UK and South Africa have held up well due to higher exposure to oil and mining companies.

This, together with our Rand which was unusually strong during 2021, culminated in strong equity market performance and tax revenues which are significantly higher than expected which has benefited us.

### Why is inflation important for the economy? When is it a concern? And how is it controlled?

Reasonable inflation increases are good for economies, because price increases are an indication of increased demand. As demand for a product or service increases over time the price of that product or service will increase, which in turn triggers increased production or supply. Inflation within expectations, is therefore a good indicator of economic growth.

Central Banks across the globe (in our case the South African Reserve Bank (SARB)) aim to control inflation within expected bands by changing what they call the repo rate. Repo rates are simply the rate at which they lend money to commercial banks. An increase in repo rates automatically results in those banks increasing their rates. For example, your home loan repayment increases, the monthly installment on your car goes up, and you pay more for your credit card debt!

The theory is simple. If you have to pay more towards what you owe the bank, you will have less money available for spending elsewhere. This in turn reduces demand and drives down prices, and in turn brings down inflation!



## Does inflation impact my investments?

Higher inflation and higher repo rates do not only affect the repayment of debt. There is also an impact on the price of investments. For example, bonds (a type of fixed-income investment) often experience negative returns during periods of higher than expected inflation and interest rate increases. This is because their prices are determined by calculating the present value of the expected future repayments by using the current repo rate. The relationship between the price of a Bond and the interest rate used to calculate its value has an inverse relationship. Simply put, if the interest rate increases, the price of the Bond reduces, and vice versa.

Real assets like commodities and property are expected to experience positive returns during inflationary periods, as the related income generally increases with inflation.

Share prices are not expected to show notable differences during period of higher inflation, as companies' prices are expected to keep up with inflation. However, this is based on the assumption that companies are able to pass on all increased costs to the consumer and maintain their sales, which practically is not always the case. As we mentioned earlier, as people have less money left after paying for their home loans, car repayments and credit cards, they will have less discretionary spending money, which can affect businesses revenue and profits. So, the share prices of some companies are not only impacted by rising interest rates but also reducing consumer demand.

It is therefore important to note that the impact on different asset class prices as stated, are overarching statements. The exact impact on returns are also highly dependent on different investment circumstances and company strength.



## How else is inflation used in investments?

When inflation is within the expected bands it creates market predictability and certainty, often leading to more stable returns. However, markets tend to react sharply to unexpected results and therefore unexpected changes to indicators like inflation can cause large market reactions and downturns.

Inflation also serves as a measurement yardstick for investors. With an understanding of overall price increases, investors are able to assess whether the value of their investments has maintained, been reduced or exceeded its buying power over time.



## Why has inflation become a concern in 2022?

The absolute percent of inflation is considered significant when it falls substantially outside the expected inflation bands of a particular country or region. For a developed country like the USA, inflation is expected to be around 2% per annum, while for developing nations like South Africa (SA), inflation is targeted within a band of between 3% and 6%.

Over the last year, inflation has rocketed globally. USA consumer inflation peaked at more than 9% during June 2022, compared to average inflation of 1.6% between 2009 and 2020. Some of the reasons cited for high USA inflation included:

- Russia – Ukraine conflict spurring food, oil and gas inflation through global shortages of these commodities since February 2022. Russia and Ukraine are large exporters of oil, gas and wheat. Russian sanctions and unrest in Ukraine have limited this supply to the Western world, forcing prices up.
- Supply chain bottlenecks. Since 2020 the global shortages of products occurred as non-essential manufacturing was drawn to a halt for a few months as a result of Covid lockdowns. During 2021 these supply chains slowly improved but the most recent Chinese lockdowns following their Zero Covid Policy during the first half of 2022 further limited supply, driving up the prices of goods globally.
- Low USA unemployment rates at 3.6%, combined with wages increasing above 7% in 2021, and strong fiscal stimulus through income grants during the Covid pandemic in 2020, created excess money supply in 2022.

In South Africa, CPI reached 7.4%, exceeding the upper target as set by the Reserve Bank at 6%. This was because of the increase in food and fuel prices, aggravated by the Russian-Ukraine conflict. In addition, electricity prices rose by 14% placing further pressure on the middle class.



## What to remember as long-term investors?

The graph below shows the cumulative investment return for the SA JSE All Share Index since the 1960s. It shows both global and local events which at times have led to sharp declines and the subsequent recovery thereafter.



As retirement savings are targeted for the long term it is important to remember that while concerns may arise from time to time, the effect on investments tend to be temporary. From the chart it is clear that despite any sharp declines, the market has tended to recover and achieve better heights than before.

One feature of investment markets though, is that it is near impossible to correctly time the up- and down swings of returns. The effect is that one must endure the pain to take part in the recovery. The key is therefore to remain invested through the volatility to be able to gain advantage of good long-term returns.

For changes to the Old Mutual SuperFund suite of investment offerings, [click here](#).

## Wrapping Up...

We hope this newsletter has explained what inflation is and the impact of rising interest rates will have on investments and to always focus on the long term goal of your retirement savings.

Look out for the last investment update for this year!

