Trustee Tutor: Issue 10 – Macroeconomics and retirement fund investments

Retirement funds and their investments don't take place in isolation. They form part of, and participate in, a larger market (or economic) environment. It is important that trustees are aware of developments and changes in the broader environment and how these can, and will, impact the investments in their fund. This awareness helps trustees communicate these impacts to members in a way that they are able to understand and appreciate how their fund balances may change.

What is macroeconomics?

Macroeconomics is a branch of economics that studies how an overall economy - the market or other systems that operate on a large scale - behaves.

Macroeconomics studies economy-wide phenomena such as inflation, price levels, rate of economic growth, national income, gross domestic product (GDP), and changes in unemployment.

Source: Investopedia

Macroeconomics covers the structure, performance, behaviour and decision making of the economy as a whole, or simply put, the big picture scenario of the economy. And macroeconomic factors will impact the monetary stability related to the whole economy of a country or region.

As a trustee, you can immediately see that you are not able to influence the overall economy, or the various macroeconomic parts of it. It is thus important to appreciate how each impact on your fund and its investments in order to understand and, where possible, mitigate the risks your fund is exposed to.

South Africa is part of a worldwide economy

South Africa participates in the global economy. The consequence of this is that any events in the world will have an impact on our local market, and thus on your retirement fund.

There are many macroeconomic influences on your retirement fund. These may be economic, geopolitical and environmental events.

As we unpack some of these, you'll see that many are interconnected and a change in one, can impact others.

Economic factors

Economic growth

The overall health of a country's economy has an impact on its investment market. When the economy is growing, companies have the potential and opportunities to grow their business and thereby increase profits (which can increase share prices). A strong economy tends to give investors confidence in the equity market. What's more, consumer spending increases when the economy is strong because people feel more confident about their personal finances.

A consumer is a person who buys goods or services for their own personal use.

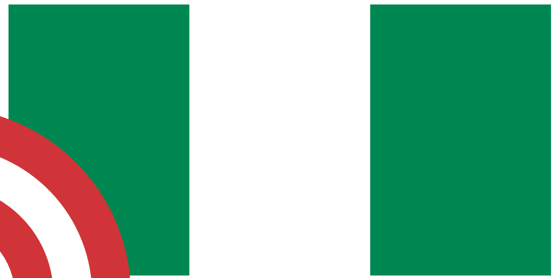
The opposite is also true: when the economy is slowing then companies will find it harder to expand. And if consumers are not very confident of the future, they will choose to save instead of spending money on non-essential items. Investors will also look to protect their capital and move their investments into "safer" investments, like bonds.

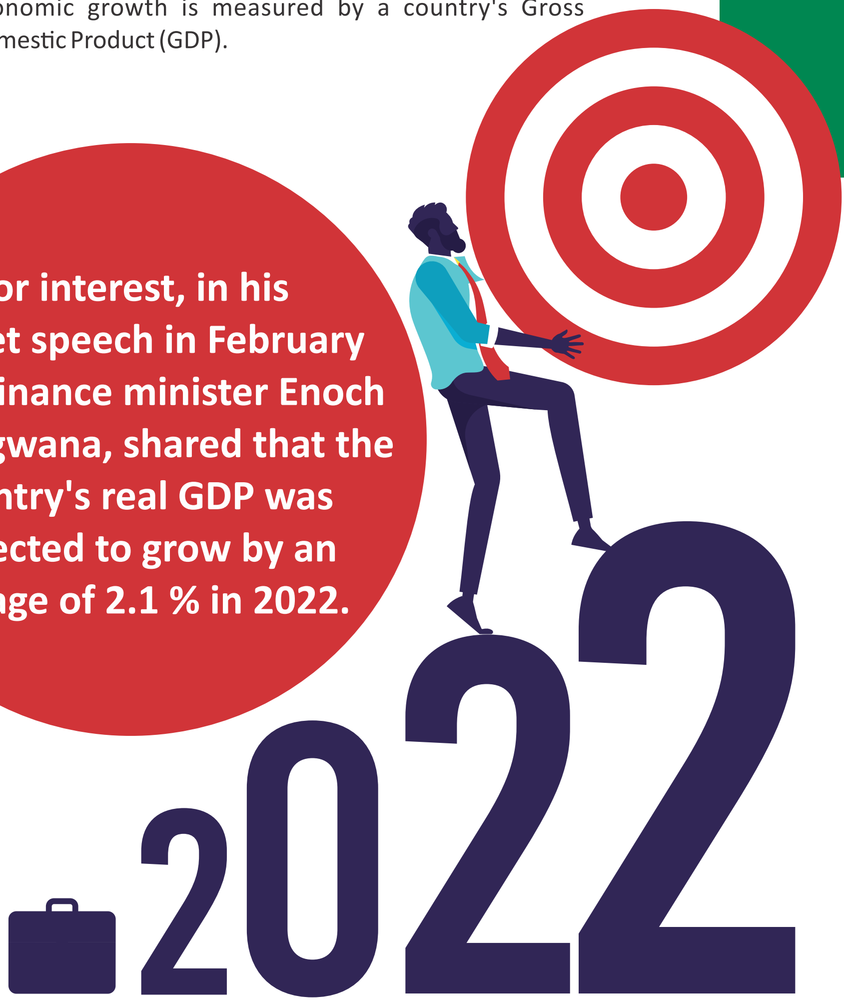
Economic growth is measured by a country's Gross Domestic Product (GDP).

Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. Source: Investopedia

When trying to understand the broad economic health of a country, changes in its GDP is the most comprehensive measurement an investor can look at, as it provides an economic snapshot of the size of the country's economy and its growth rate.

At the end of 2020 **the World Bank valued South Africa's GDP at US$ 335,44 billion**. For interest, China was valued at US$ 14,72 trillion, the United States at US$ 20,95 trillion and Nigeria at US$ 432,29 billion (Nigeria being the biggest economy in Africa).





For interest, in his budget speech in February 2022, finance minister Enoch Godongwana, shared that the country's real GDP was expected to grow by an average of 2.1 % in 2022.

South Africa's GDP grew by 4.9% in 2021. As a statistic, this is meaningless standing alone and again must be considered in a broader context. It becomes meaningful when we consider that, at the end of 2021, South Africa's real GDP continued to lag pre-pandemic levels and the economy was 1.8% smaller than it was in the first quarter of 2020 (the start of the Covid 19 pandemic in SA).

Then, one can consider this growth on the context of other countries, like Nigeria's at 3.4% or China's at 8.1% in 2021, to be in a position to compare economies, getting a more complete and meaningful picture as an investor.

Unemployment

The unemployment rate of a country is another marker of its economic health.

This is because wages are the biggest indicator of consumer spending. A high unemployment rate means that many people don't have jobs, thus don't earn salaries or wages and consumer spending drops. With limited money available, consumers will allocate spending to essential items (food, data, fuel, etc) and spend less on luxury, non-essential, items.

This limited consumer spending will restrict the earning capacity of companies which then affects their share prices. Consumer essentials and defensive sectors are usually the better performing shares in a high unemployment environment.

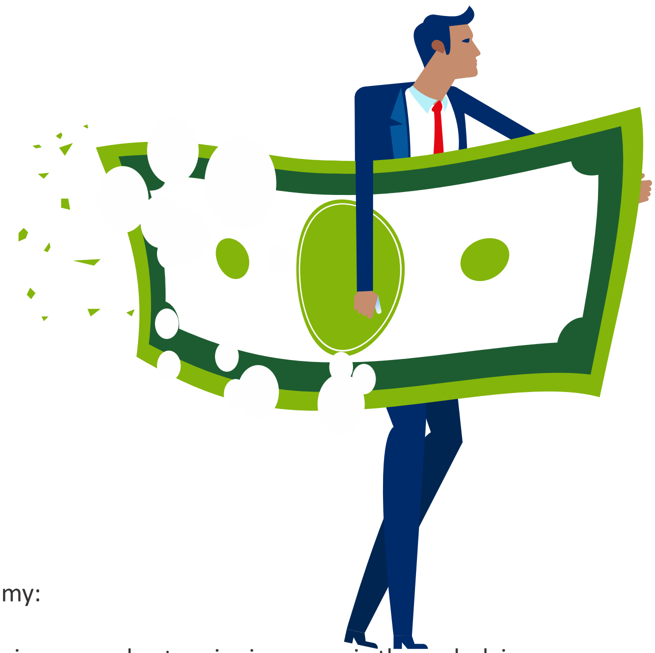
By contrast, when the majority of a country's population is employed, peoples' spending increases the amount of money in circulation and boosts the economy.

South Africa's **unemployment statistics reached a record high of 35.3%** in the last quarter of 2021. If you consider our earlier mention that GDP growth was 4.9% in 2021, it is concerning that the official unemployment rate was still 2.8% higher than the 32.5% recorded in Q4 2020 – meaning that the country's growth in 2021 did not result in more jobs.

Unemployment not only affects consumers' pockets, but also the investment into a country as a whole. One could argue that high unemployment was a contributing factor to the unrest experienced in South Africa in July 2021. Riots like those experienced in KwaZulu Natal may scare off overseas investors.

Inflation

Inflation is the general rise in prices in an economy, reflected in the increase of the average price level of a basket of selected goods and services over time. The most common measure of inflation is the Consumer Price Index (CPI).



Inflation is the reason why you are able buy less and less with R100 each year that goes by. It is thus vital that the members in your retirement fund enjoy real investment returns during their time in your fund. Said differently, your fund's investments should produce returns that are higher than inflation over the long term.

Factors that drive inflation

The following are factors that drive prices, and thus inflation, in an economy:

Cost-push inflation occurs when the price of producing goods or services increases due to price increases in the underlying production materials or processes, like raw materials or wages. For example, if the cost of copper increases, all the products or services that use copper will experience an increase in their production costs – which will result in an increase in the costs of those goods and services. To bring this idea closer to the man in the street's pocket, think about how the recent increases in the cost of petrol will increase the cost of moving goods around the country, and thus result in higher prices.

Demand-pull inflation is caused by strong consumer demand for a product or service. As the demand for a particular product increases, customers are prepared to pay more for the item. As an example, think about the cost of red roses a day or two before Valentine's Day!

What does inflation mean for your retirement fund?

It is important that trustees (and members) understand the role that inflation plays in their retirement savings journey. Many members are nervous of investment risk – or more specifically, they are nervous of losing their retirement savings during times of short term market volatility and thus choose to invest in "safer" investment options, like cash. While investing in cash, and other near cash investments, may deliver more predictable returns (and no negative returns) their savings are not earning returns above inflation. This means that the value of their investments are eroding over time, they just don't see it.

The National Treasury predicts headline inflation at 4.8% in 2022. As a trustee, you need to monitor inflation and make sure that the investment options you make available to members provide the best opportunity for real returns. The vast majority of retirement funds make use of investment managers, or multi managers. Trustees must monitor that their appointed investment managers remain committed to beating inflation and providing overall real growth to investors.

Interest rates

Interest is the amount of money a lender (or financial institution) receives from a borrower for lending out money. The interest rate is the percentage of the amount borrowed that the borrower pays the lender.

Put simply, consumers (and companies) pay interest on any money that they borrow.

In South Africa the South African Reserve Bank (SARB) sets the repo rate which is the rate at which the SARB lends money to commercial banks. The current repo rate is 4.25% and the current prime interest rate is 7.75%.

High interest rates negatively impact the share market. Shares usually sell off when there is any talk of a rate increase in the future. High interest rates also restrict the ability for companies to borrow money, which can slow down their ability to grow. This slowing in business growth can affect earnings growth and then share prices.

Rising interest rates also affects consumers as they experience an increase in loan payments leaving them with less money to spend. This could create less demand for non-essential goods and services which then affect company earnings and share prices. As demand starts to drop off, investors could also then expect a drop in inflation.

It is well known that policy makers use interest rates to moderate an economy. In South Africa, the SARB uses interest rates to influence the level of inflation. In practice, National Treasury, in consultation with the SARB, sets the inflation target, which acts as a benchmark against which price stability is measured. The SARB then independently makes monetary policy so as to achieve this target.

The basic aim of monetary policy is to determine how much money an economy should have in circulation. The monetary policies of countries may differ, but most major economies aim for low and stable inflation, and have publicly announced inflation targets.

To protect the value of the rand, the SARB uses inflation targeting, which aims to keep CPI between 3% and 6%. The value of the currency is therefore protected relative to domestic consumer prices.

Exchange rates

An exchange rate is the price of one country's currency in terms of another currency. In other words, it is the rate at which one currency will be exchanged for another.

As an example, as I'm writing this, you would have to spend R16,07 to purchase US$ 1.

Factors that influence a country's exchange rate include:

- Interest rates
- Trade balance
- Political stability or instability
- Inflation rate
- General state of the economy

You can see that, as mentioned earlier, the macro-economic factors are all linked to each other – and a change in one, will lead to changes in others.

South Africa has a floating exchange rate (also known as a fluctuating or flexible exchange rate). In a floating exchange system, the price of a currency is set by supply and demand. When supply increases and demand decreases, the price of a currency will fall. The opposite is also true, increased demand and lower supply will increase the price of a currency.

A weak exchange rate means exports are cheaper internationally. This is good news for South African companies that export goods and services overseas as demand increases and earnings rise. A high exchange rate may mean cheaper imports, which is good news for local companies that use imported goods such as electronic retailers or manufacturing companies.

However, a strong exchange rate may also cause some companies to struggle as the price of the goods and services become uncompetitive compared to other countries.

The rand's fluctuations in value relative to other currencies affects both the broader South African economy, and the individual investor's pocket as the prices of goods and services changes in response to these fluctuations.

Geopolitical factors

Geopolitics is the study of how geography and economics have an influence on politics and on the relations between nations. *Source: Britannica dictionary*

Examples of geopolitics includes trade agreements, war treaties, border or territorial recognitions and climate agreements.

There is no doubt that a country's politics affects its economy, and its exposure to wider, global geopolitical risks has become a recurring and material cost of doing business. Examples include the ongoing US-China strategic competition, tensions in the Middle East, emerging markets debt crisis, and potential knock-on effects to Europe following Brexit.

Most recently, Russian's invasion of Ukraine on 24 February 2022, and the tightening sanctions on Russia, led to increasing prices of goods which will have a negative impact on inflation in South Africa. The invasion has directly led to higher oil and grain prices, which directly push up prices of key goods such as fuel and bread.

These price increases will directly affect the South African consumer (and your retirement fund investor). The implications of these types of political tensions are monitored by investment managers and considered when they construct their investment portfolios for your retirement fund members.

Environmental factors

The natural world also impacts economic growth and recession. Natural disasters (for example, earthquakes or cyclones), diseases and pandemics (for example Covid 19) and the impacts of climate change all affect global and local investors.

According to a recent report produced by a large international insurer, globally there were 401 natural disaster events in 2021, which led to economic losses of $343 billion - about R5.2 trillion. Specifically, South Africa's economic losses came to over $175 million - about R2.7 billion.

The imperative of climate change should not be news to any trustee. What is specifically relevant to the South African investor is the increased incidents of cyclones off our east coast, which brings home the heightening effects of climate change in the southern region of Africa. Recent tropical storms include Ana (Mozambique, January 2022) and Basirai (Madagascar, February 2022). Research shows that tropical cyclones have a significant impact on the economic, social and environmental integrity of the affected communities.

No conversation around macroeconomic environmental factors would be complete without a mention of the **Paris Agreement,** which covers climate change mitigation, adaptation and finance, and was negotiated by 196 parties, including South Africa, in 2015. **The Paris Agreement's long term temperature goal is to keep the rise in mean global temperature to well below 2°C and emissions should be reduced as soon as possible and reach net-zero by the middle of the 21st century.**

More and more investors and portfolio managers are interrogating the environmental impacts of their investments, in other words, focusing on the E in ESG investing. (For more information on ESG investing, read the Trustee Tutor in the Q4 2020 edition of Pensions World.) Discerning investors will seek out sustainable investments that will provide them with good returns without damaging the environment. Companies (and countries) that produce sustainable products that are kind to the environment will be the net winners.

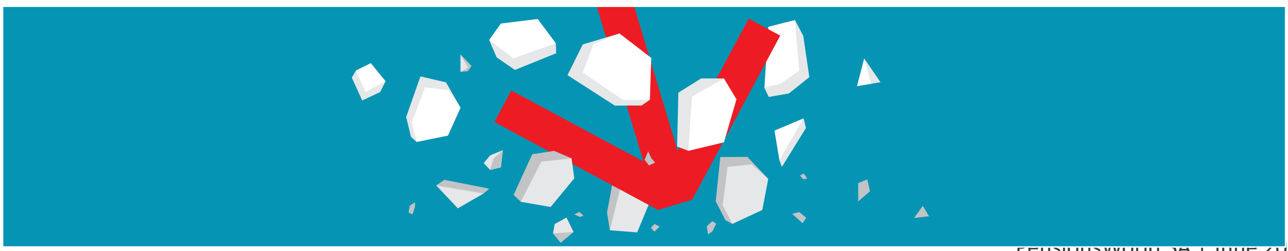
Sentiment

Although not a macroeconomic factor, sentiment is one of the broader market influencers that investors need to be aware of.

Sentiment refers to the overall attitude of investors toward a particular security or financial market. It is the feeling or tone of a market, or its crowd psychology, as revealed through the activity and price movement of the securities traded in that market. *Source: Investopedia*

Market sentiment can be:
- **Bullish – when prices are increasing; or**
- **Bearish – when prices are falling.**

Sentiment is not always based on market fundamentals, in other words, market sentiment is about emotion, whereas fundamental value is about business performance. Sentiment drives demand and supply, which in turn leads to price movements. And in this space of emotion or feelings about particular shares, some investors are able to realise great investment returns, by finding shares that are overvalued or undervalued based on what the crowd thinks or expects.



The tools in government's toolbox

There are strategies, or tools, that governments use to control and protect their economies within the larger macroeconomic landscape.

Fiscal policy refers to the use of government spending and/or tax policies to influence market conditions, like employment, inflation and economic growth. As part of an expansionary fiscal plan, the government might stimulate the economy by cutting taxes or increasing spend on infrastructure projects. Both of these strategies increase the disposable income available to consumers, who then spend more. This increase in consumer demand, could result in an increase in inflation. An example of this is the government's issuing, and extension of, the Covid 19 social relief grant, designed to sustain households financially during this natural disaster and stimulate economic activity.

Monetary policy sits in the toolbox of the central bank, in other words the SARB. As discussed earlier, the SARB can influence the economy by controlling money supply or by adjusting the interest rates. The lowering of interest rates will mean that consumers are able to access cheaper debt leaving them with more money available to buy goods and services. This increased demand will more than likely impact inflation.

In conclusion, retirement fund savings and investments take place in a broader economic landscape. Trustees need to understand the external, or macro, economic factors that will impact on the investments they choose to make and the returns that these investments will earn. An understanding of the relationships between these factors is critical to be able appreciate the inter-connectedness of investment factors, to be aware of why portfolio managers make the decisions they make and how these will affect other parts of the retirement fund's portfolio.