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ECONOMIC COMMENTARY - By Dr. Francois Stofberg

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JULY ECONOMICS: CHINESE REGULATIONS AND INFLATION

In a recent newsletter, I briefly mentioned our concern around regulatory uncertainty in China. In July, however, this became one of our main themes after the MSCI China, a broad index that tracks the Chinese equity market, fell by 18.8%. Driven by regulatory uncertainty, a decrease of this magnitude wiped out the relative outperformance of Chinese equities since 2017 and brought price-to-earnings (P/E) valuations down to slightly below their average of the last five years.

There is considerable uncertainty about the reason for China's recent regulatory ramp-up. One such reason is the new rules introduced by the Cybersecurity Administration of China, who have banned companies with more than 1 million users from listing on offshore stock markets without passing security review and receiving official permission. Regulatory scrutiny has been so tough that mere rumours about DiDi's potential delisting from the New York Stock Exchange caused the share price to appreciate by as much as 49% in pre-market trading. Even after the company released a statement denying delisting rumours, the stock still ended 12% higher on the day.

Some analysts speculate that the regulatory ramp-up is aimed towards reigning in individuals or individual companies, such as Jack Ma and his company Ant Group. Others maintain that regulators want to rein in the profits of those industries that have become uncompetitive and a burden to consumers. Yet others believe that it is merely a series of independent agency events; not a reason that we support. Whatever the reason might be, it is reasonable to believe that, if the external sell-off continues to cause greater damage to onshore capital markets, there would likely be government intervention to restore confidence. Considering this, as well as the recent sell-off, there is little reason to hold a negative outlook on the index for too long.

Another main topic during July was that of inflation, both globally and closer to home in South Africa. The buzzword was "transitory", i.e. temporary, as central banks around the world tried to figure out whether the recent spikes in inflation were, in fact, transitory or more permanent. Our view on the matter has remained unchanged: prices should ease, leaving central banks with no real reason to increase interest rates too soon, other than attracting capital, of course.

While on the topic of inflation: as we moved on from another season of quarterly reports, leading global consumer-goods companies, such as Nestlé, Diageo, Anheuser-Busch InBev (AB InBev) and Danone, have all highlighted that sales are rising as key markets start to flourish post-pandemic. They were also quick to add that the rebound was leading to rapidly-increasing input costs, such as the ingredients that go into the production of their products, but also packaging and transport costs.

Consequently, Nestlé has already increased prices by an average of 1.3% globally in the first half of 2021. Price increases have, however, fallen hardest on countries in North America and Latin America. Nestlé's milk-based products (all our favourite chocolates) and ice cream prices were up by an average of 3.5%. Overall, Nestlé expects input costs to be 4% higher this year, which might lead to more price increases for consumers. Spirits maker Diageo will also be raising prices on brands such as Baileys and Casamigos tequila. AB InBev is exploring higher prices for its beers; most of which are enjoyed by many South Africans. From an investor's perspective, higher prices that are passed on to consumers is a good thing, as it means that profits are being preserved. But, from a consumer's perspective, it really hurts your pocket at checkout.

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