

Counting the cost of *conflict*

Why it's bad, but could have been worse

by Alida Malherbe

The war in Iran is steadily closing in on the three-month mark. Initial hopes for a short, sharp conflict that would see its impact remaining contained have long since faded. Instead, hopes are now that the conflict won't be overly protracted – and that it won't re-escalate. Steady but continually changing news flow and sharply shifting sentiment make events as impossible as ever to predict. However, it's becoming increasingly clear that the implications will be far reaching, on a global scale.

South Africa, as a small, open economy and an oil importer, will not be spared. However, it is worth reflecting that while we will certainly feel some pain, the blow will be blunter than it might have been just a few short years ago. Let's look at a few reasons why.

1 | The starting point matters

Heading into the conflict, South Africa was in the strongest position it had been in for some time. Ongoing structural reforms had started to gain momentum, both under Operation Vulindlela and at policy-setting level, with the country being successfully removed from the Financial Action Task Force grey list and decisively

adopting a lower inflation target. As a commodity exporter, we had also benefitted from a period of high commodity prices, leading to strongly positive terms of trade (higher export prices relative to import prices).

All against the backdrop of a stable Government of National Unity, markets and market watchers took notice. S&P notched up our sovereign credit rating (also assigning a positive outlook) and the country attracted renewed investment interest, further supported by improved sentiment towards emerging markets more broadly. The rand strengthened, government bond yields moved lower (reflecting a more favourable risk assessment by investors) and inflation was well contained around the South African Reserve Bank's (SARB's) new 3% target. In combination, it served to add a little fat to National Treasury's

coffers and provided the SARB with a good starting point to better navigate inflationary pressure.

2 | The ship remains steady

While not new, it is certainly worth reflecting on the steadfast credibility of our monetary authorities. When tabling the National Budget in February, National Treasury reaffirmed its commitment to stabilising the country's debt burden after years of progressive deterioration. This was underscored by restraint shown in planned expenditure, against what many argued were overly conservative revenue assumptions given the recent commodity boom. However, it was precisely this conservatism that allowed Treasury the leeway to announce temporary fuel levy relief – at a cost of over R17 billion – between April and July, partially shielding motorists, commuters and logistics operators from sharply higher petrol and diesel prices. It will also help to contain the associated inflationary impact, with the Bureau for Economic Research estimating that the intervention shaved off 0.7% from South Africa's headline inflation print for April.

The SARB was also conservatively positioned ahead of the war. Despite low inflation, it had maintained a moderately restrictive monetary policy stance, in light of escalating geopolitical tensions. It will likely still be required to respond with higher interest rates to prevent an oil-price-induced inflation shock from becoming more deeply entrenched. However, having not cut interest rates too quickly into the recent easing cycle, its hikes will also be less severe. Importantly, the SARB remains committed to its 3% inflation target and confident in its ability to entrench it. Its most recent projections, which employ scenario analysis to stress the severity of the inflation outcome and the extent of the interest rate response required, all have inflation returning to 3% over time.

3 | We are one year loadshedding free

In what has become the poster child for South Africa's structural reform agenda, Eskom recently marked a full year without loadshedding. While energy reforms remain ongoing, it is certainly worth pausing on this significant milestone. It is also worth reflecting on the fact that this has dramatically lowered South Africa's diesel consumption. Eskom is no longer reliant on the extensive use of diesel-run open-cycle gas turbines (OCGTs) to keep the lights on. The benefit is also very real for businesses and households who used generators for back-up power, and for farmers who relied on

generators to manage the devastating impact of power outages on irrigation systems, cold storage chains, and broiler house ventilation systems. If we consider that Eskom's OCGT diesel spend alone escalated from around R5 billion a year before widespread loadshedding to over R20 billion a year at its peak, it's a real relief not to carry this additional concern.

What are we doing with our fixed income exposures?

All this is not to say that South Africa won't feel the impact of the war in Iran. We already are.

We are also cognisant of broader and longer-term implications, such as disruptions to global fertiliser supply, adjustments higher in shipping and insurance rates, and the overall impact that the confluence of all these factors could have on global growth and inflation.

Without trying to predict how any of this may play out, we are positioning client portfolios to account for different potential outcomes and remain alert to opportunities presented by market volatility or excessive pessimism. For example, while having trimmed positions in inflation-linked bonds (ILBs) across all our portfolios following their recent rally, we maintained exposure to shorter-dated ILBs. Here, our funds were able to lock in attractive real yields in addition to the inherent inflation protection provided, which will serve clients well in an inflationary environment.

In addition, in the Granate BCI Mult Income Fund, we are favouring medium-term nominal bonds over longer-dated exposures. As the market has moved from pricing in two interest rate cuts this year to pricing in close to four interest rate hikes, we believe there is good risk compensation on offer, especially if the interest rate path is less severe than suggested. In our Granate BCI Active Bond Fund, Granate BCI Balanced Fund and Granate BCI Flexible Fund we remain comfortable taking positions in slightly longer-dated nominal bonds, where there is favourable risk compensation that may come at the cost of shorter-term volatility.

Our focus is to remain watchful, informed and agile. And our commitment - to grow and protect your savings - remains steadfast even when it may feel as though little else is.

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