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OUT OF THE ORDINARY

Global Investment View

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Recession on the horizon, but market bottom approaching

By Chris Holdsworth, chief investment strategist, Investec Wealth & Investment and Chair of the Global Investment Strategy Group

The Global Investment View distils the thinking of the Global Investment Strategy Group that brings together the insights of Investec Wealth & Investment's professionals in the UK, South Africa and Switzerland. The Group meets quarterly to map out our outlook over the following 18 months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.

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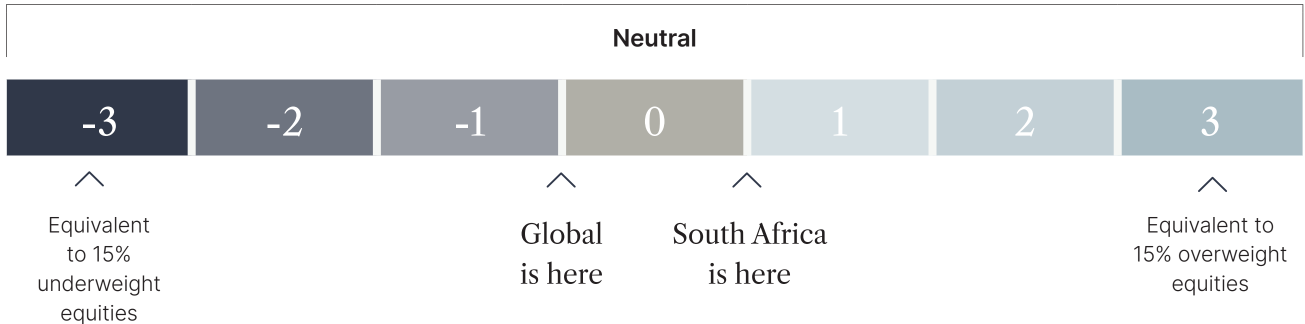


Summary

We expect both the US and Europe to shortly go into recession. This is likely to be accompanied by material downward revisions to earnings expectations, leading equities to underperform fixed income by 5-10%, in our view. Given the risk to markets, we would prefer a larger margin of safety than is currently on offer for US equities. While we are in the part of the cycle with elevated 'gap' risk (the risk that markets will fall sharply on bad news), we are also getting closer to the end of the cycle and given that the beginning of a new cycle is typically characterised by outsized returns, we are waiting for the opportunity to increase the risk score.

South Africa should be a beneficiary of stimulus in China but there has been an increase in South African political risk that could offset any gains. It is worth emphasising that the aggregate SA equity market is largely unaffected by South African-specific developments thanks to the large weighting in the indices of counters that generate significant portions of revenue and profit offshore. While South African fixed income is affected by South African-specific factors, it also offers a large margin of safety.

"South Africa should be a beneficiary of stimulus in China but there is an increase in South African political risk that partly offsets any gain."

Our rationale:

US and European recession is our base case

A wide variety of indicators suggest that both the US and Europe will shortly go into recession. We expect recessions in both areas but also expect that they will be of the milder variety – large excess savings should smooth consumption in the US and the recent decline in gas prices in Europe imply a less steep contraction in economic activity than expected a few months ago. While recession is widely expected by market participants, consensus earnings forecasts still seem implausibly bullish. The prospect of material earnings downgrades, combined with the non-negligible chance of a worse-than-expected recession imply significant tail risk (a risk of a sharp fall due to a rare event) in global equities over the coming 12 months.

Growth weak, low levels of liquidity

Six-month US M2 money supply growth is running at -1%, the lowest reading in at least 40 years. US growth is weak too. The 12-month period from Q1 22 to Q1 23 is likely to see US GDP growth of just 0.6%, implying a 12-month growth rate in the bottom 10% of observations since 1980. The combination of weak GDP and money supply growth supports a continuing risk-off position.

Inflation to surprise on the downside

US inflation has started to surprise on the downside and we expect this to continue over the coming 12 months. Chinese PPI inflation is negative, the cost of shipping goods across the globe is down 75% off the peak, there is a record number of homes under construction in the US that will put downward pressure on rentals once completed, and there are various signs that the global supply chain crunch is behind us.

US labour market is key

We expect a fall in vacancies and a decline in quits in the US will preceed any material softening of the labour market. It is unlikely that a recession will be called unless there is material weakness in the US labour market and we expect the Fed will only put a hold on hiking once there is sign of the US labour market weakening.

> “A wide variety of indicators suggests that both the US and Europe will shortly go into recession.”

Consequences of rate hikes are yet to be established

The current rate hiking cycle has been the steepest in at least 40 years. In addition, we have recently been through a period of sizeable cross currency volatility. We will need to wait a while to be able to accurately gauge the full impact these events will have on the broader economy and on the financial sector in particular.

Fed to continue to reduce the size of its balance sheet as guided

We expect that slowing growth will not deter the Federal Reserve from continuing to reduce the size of its balance sheet at pace. US bond market liquidity has already deteriorated and we expect continuing low levels of liquidity in US fixed income for the near future. We also expect a commensurate elevated level of bond market volatility.

Higher rates will have fiscal effects

The surge in developed market yield curves over the past year will start to have an effect on the fiscal position of their governments. Once inflation recedes, the Federal Reserve and other developed market central banks will need to follow shortly or we will see both fiscal and monetary tightening happen simultaneously.

US housing market is slowing

The median home sale price is now down 8% off the peak, according to high frequency data from Redfin. Mortgage rates are close to their highest levels since 2000 and mortgage applications have dropped to below Covid-19 lockdown lows. While new mortgages are increasingly unaffordable, there is a record number of homes currently under construction in the US – over 1.7 million homes. We expect that the US housing market will remain weak over the coming 12 months and that it will provide a meaningful headwind for equity returns. We are however not expecting anything close to a repeat of the Global Financial Crisis of 2008. Banks are much better capitalised and mortgages have been extended to consumers with much higher credit records than in the period leading up the crisis.

US market is expensive

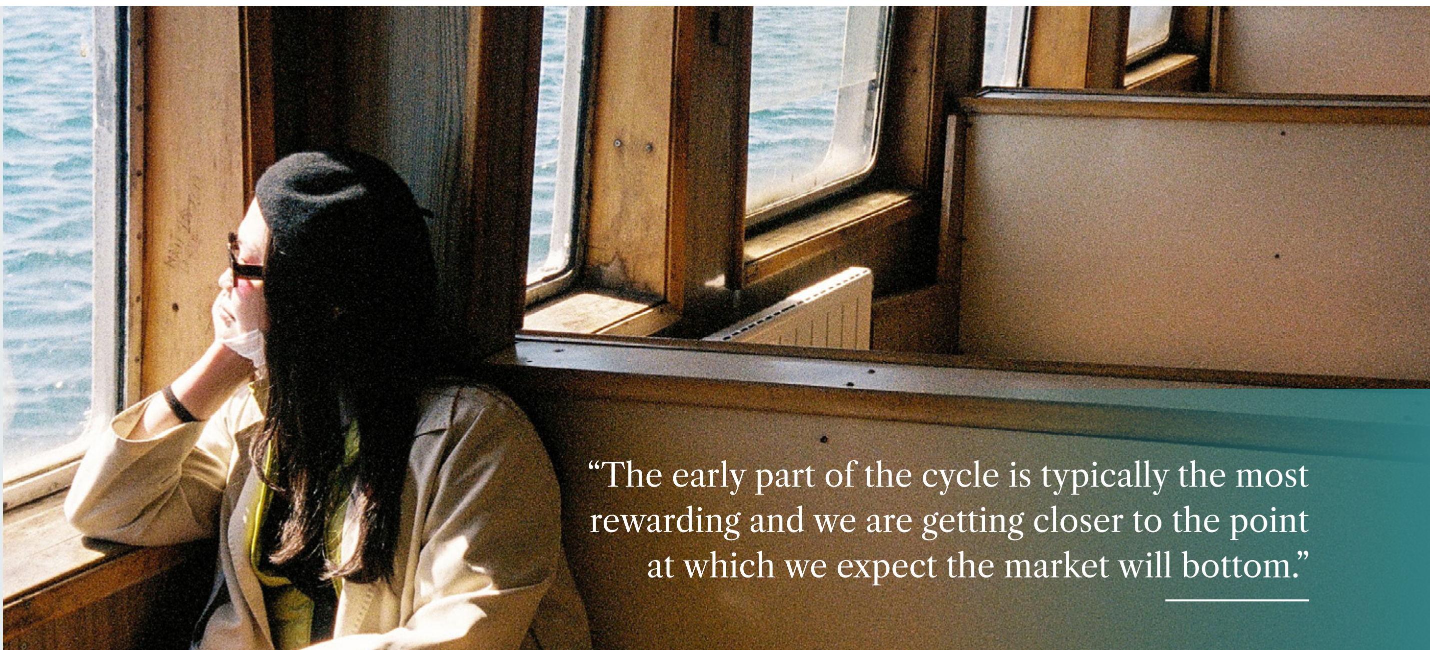
Our dividend-based model shows the US market to be about 25% overvalued. The HOLT-based implied discount for the US market is still low. The forward P/E of the US market is just over 18, a 10% premium to the 15-year median and we expect earnings to be downgraded. Whichever way one looks at it, the US market is still expensive and offers little margin of safety.

The rest of the world is looking more attractive

Both earnings and dividend-based models show that Europe, UK, and emerging markets are now below fair value.

More ‘cons’ than ‘pros’ to the market outlook

Tallying up the pros and cons to the market outlook gives a list heavily weighted towards cons. There is still ample reason for a cautious approach. Having said that, the early part of the cycle is typically the most rewarding and we are getting closer to the point at which we expect the market will bottom.



South African market view and asset allocation – political risk is elevated, but equities and bonds are cheap

Elevated political risk

There is now a material chance that the ANC loses its majority at the next general election (in 2024). This is a case where consequence may outweigh probability and we will need to be ready to shift our risk score if necessary.

Equities and bonds are cheap

The South African equity and bond markets trade at material discounts to their mid-cycle valuation. We expect most of the return for the South African market over the next year to therefore come from a rerating. The South African equity market on aggregate is somewhat insulated from South African politics thanks to the large weights of counters that generate revenue outside of the country.

South African bonds meanwhile offer a meaningful margin of safety. The slope of the yield curve is abnormally steep, both relative to emerging market peers and by historical standards. By our calculation, even if the 10-year bond yield moves up by 100bps (one percentage point) the 10-year government bond will provide a return above 4% over the coming year. However, we expect the 10-year bond yield to decline over the coming year, leading to an expected return of 10%-15% over the coming 12 months.

SA consumer income growth is slowing

It is somewhat concerning that employee tax receipts have risen by below 4% year-on-year for two months in a row. Combined with the rising cost of debt, it implies a pretty dire position for formal sector employees. Should we see the current trend continue, we will need to materially reduce our allocation to “SA Inc” shares.

The South African equity market on aggregate is somewhat insulated from South African politics thanks to the large weights of counters that generate revenue outside of the country.

Chinese inflation is low – providing scope for more stimulus

Towards the end of last year, we saw a number of policy announcements in support of growth from the Chinese authorities – a cut in the required reserve ratio, an easing of the zero covid approach and support for Chinese property developers. The net result has been a surge in commodity prices and a large rally in Chinese exposed equities. There is ample space for more stimulus from the Chinese authorities – Chinese inflation is running at just over 2% – and we expect more to come.

Commodities to do well

It is not often the case that commodities do well when developed markets go into recession, but we think this time may be an exception. China is stimulating, we expect the US dollar to weaken and the global energy transition should provide a meaningful tailwind for commodity prices. In addition, miners have shown an unusual level of supply discipline over the current cycle – which should provide support for commodity prices.

Eskom risks remain elevated

Even under Eskom's base case, SA is likely to experience regular loadshedding over at least the coming year. While companies have found ways to cope with load shedding, either through generators or solar, this comes with a cost and Eskom remains a binding constraint on growth in SA. We do not expect this to change in the coming year.

Asset allocation:

The committee has kept its SA risk score at 0.5. Both South African bonds and equities receive an overweight allocation.

Equities: Screen cheap. Remain overweight SA plays and SA resource counters.

Bonds: Large margin of safety offsets elevated SA political risk. Overweight.

Cash: While cash rates have increased, they are still well below inflation, we prefer to allocate to risk through the domestic bond market.

Property: We prefer increased exposure to SA yields through the government bond market.

Gold: Overweight as a hedge against SA specific risks.

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Asset allocation positioning:

The metrics below show our asset allocation positioning for global, domestic and by theme.

-- Underweight

- Moderately Underweight

N Neutral

+ Moderately Overweight

++ Overweight

GLOBAL ASSET ALLOCATION	Q4 2022	Q1 2023	COMMENTS
Global Equity	-	-	GISG score negative. Market screens as expensive, with further monetary policy tightening to come. Sizeable earnings downgrades on the horizon too.
Global Fixed Income	+	+	There is now a margin of safety in global fixed income, especially US nominal bonds.
Global Cash	+	+	Still overweight given global uncertainty.
Emerging Markets	N	N	EM equities screen as cheap value, in contrast to DM equities.
Global Property	-	-	Valuation still elevated relative to long-term average.
Global Alternatives	+	+	Offers attractive risk-adjusted returns relative to traditional long-only asset classes. Variations include return-enhanced, capital-protected and low correlation products.

LOCAL ASSET ALLOCATION	Q4 2022	Q1 2023	COMMENTS
SA Equity	N	N	SA equity market cheap. However global headwinds will still be strong for the forseeable future.
SA Fixed Income	+	+	Still significant margin of safety in SA debt in our view. Elevated political risk though.
SA Cash	-	-	We prefer to be exposed to the longer end of the curve and use gold as an insurance asset. Underweight in cash to allow for overweights in our risk-on positions.
SA Listed Property	-	-	Less of a domestic interest rate play than historically - expect to be driven by fundamentals. Prefer to express the view through the fixed income market.
SA Preference Shares	N	N	Very strong performance has moved valuations close to fair value.
USD/ZAR (+ for ZAR strength)	++	++	USDZAR meaningfully weaker than our estimate of fair value. We expect USD to weaken over the coming 12 months.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks, particularly the risk of higher than expected inflation. Rising real yields a concern though. Looking to reduce to neutral.

SECTORAL/THEMATIC POSITIONING	Q4 2022	Q1 2023	COMMENTS
Global Plays	N	N	Neutral. Valuation less of a concern than before.
Commodities	+	+	We expect commodity prices to continue to surprise on the upside. Resources cheap in our view. Offshore resources a hedge against Eskom risk.
Precious Metals	-	-	Risks to the gold price ahead, better opportunities in diversifieds and SA Inc.
SA Plays	+	+	Cheap. Elevated political risk though.
Small/Mid cap	+	+	Valuations still attractive and investor appetite starting to increase.

*A neutral indication can mean a zero allocation versus zero benchmark exposure

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