Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q3 2022

Contents

Looking for downside inflation surprises

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.

Chris Holdsworth, CFA

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Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Investec Wealth & Investment South Africa. His research covers asset allocation and sector selection, both locally and internationally. Chris comes from the research team in Investec's equity business, where he was an investment analyst for 12 years, covered investment strategy for six years and has headed up the research team for two years. He is also a member of the Global Investment Strategy Group (GISG).

GLOBAL WEALTH AND INVESTMENT VIEW

The Global Investment Strategy Group (GISG) maintains its global risk budget score (-0.5 on a scale of +3 to -3), while the SA risk score has been increased to +1

By Chris Holdsworth, Chief Investment Strategist, Investec Wealth & Investment and member of the Global Investment Strategy Group

Summary

We expect that global inflation, and US inflation in particular, will start to surprise on the downside. This should see the Fed hiking by less than expected. However, the probability of a recession in the next 12 months has increased and as a result, growth expectations have been revised down. Earnings forecasts have yet to be materially revised and we expect this will prove to be a headwind for equity markets. We also expect that the Fed will continue to reduce its balance sheet as guided despite slowing inflation and growth. In addition, despite the recent pullback, we still think the US market screens as expensive. We remain underweight risk assets outside of SA but note that some pockets of value are now appearing, for example high yield corporate debt and US Treasuries.

European equities screen as cheap but there is a greater chance of a recession in Europe than the US, because of the unfolding energy crisis in Europe. Our global risk score remains at -0.5.

SA asset classes, in contrast, stand out as cheap. The local equity market is trading on a forward price/earnings (P/E) ratio near 8 vs 16 for the US. SA bonds offer a material margin of safety too. In addition, SA economic growth continues to surprise on the upside, despite electricity being a binding constraint on growth. The trade surplus remains extremely elevated by historical standards and SA government revenue continues to surprise on the upside due to a combination of a strong recovery in SA formal-sector incomes and continuing strong company income tax. We remain overweight SA equities and bonds.

Explaining our rationale:

Inflation to surprise on the downside

Global inflation has consistently increased over the past 18 months and has regularly surprised on the upside – initially due to a combination of rampant demand and continuing supply chain bottlenecks and lately due to surging food and energy prices. Median inflation across the largest economies reached nearly 8.5% in May.

With higher inflation have come higher inflation expectations. At the peak in March, the market was pricing US inflation to average 3.7% a year over the coming five years. US inflation has likely peaked and as base effects come into play and supply chain pressures continue to ease, we expect inflation will start to surprise on the downside.

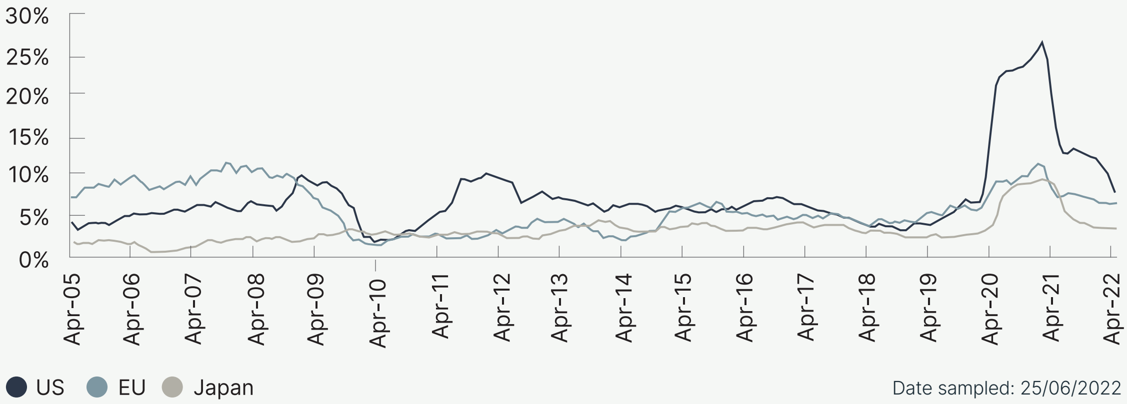
The Fed will keep reducing its balance sheet, however

While lower-than-expected inflation will likely mean that the Fed does not hike as aggressively as the market expects, we do not expect the Fed to reduce the size of its balance sheet any more slowly than it has guided. We expect that quantitative tightening will accelerate in September to $95bn/month, as guided by the Fed.

US money supply growth has slowed

As at the end of April, US M2 money supply growth was at 8% year-on-year vs the peak of 27% in February 2021. Money supply growth for the month of April was negative. Support for asset prices and inflation as a result of US M2 money supply growth is rapidly diminishing.

Year-on-year M2 Money supply growth (%)



Date sampled: 25/06/2022
Source: Investec Wealth & Investment, Bloomberg

US bond yields to decline over the coming 18 months

While we expect long-term inflation expectations will recede, we also expect that long-term real rates will continue to increase. The net result is a mild reduction in US long bond yields over the coming 18 months.

The current cycle has no more than two years to go

Central bank tightening has brought forward the point at which the current cycle ends and there is a material chance of a US recession in the near term. However, even if one occurs, we do not expect it to be severe.

The global economy is less sensitive to oil prices than before and US consumers still have access to sizeable excess savings should the labour market slow.

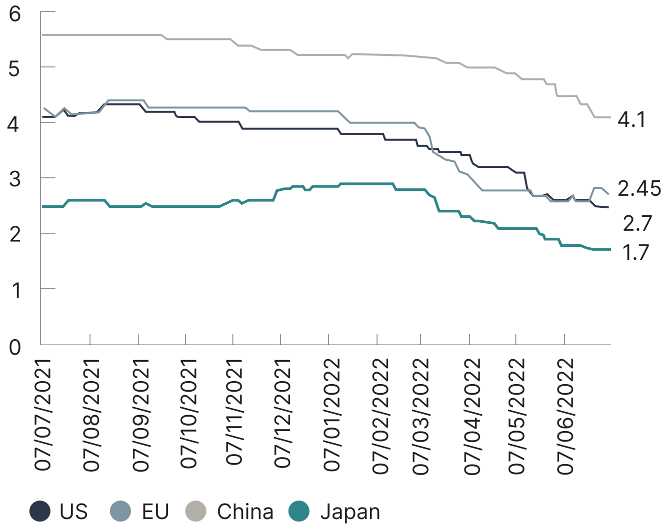
> "Central bank tightening has brought forward the point at which the current cycle ends and there is a material chance of a US recession in the near term"

Global earnings downgrades to come

The past six months have seen sizeable downgrades to GDP growth forecasts for most countries. Despite this, aggregate forecasts for the S&P 500 and Eurostoxx have not yet been materially revised down. We can expect some material downward revisions to earnings expectations over the coming few months.

> "We can expect some material downward revisions to earnings expectations over the coming few months"

Consensus forecasts for 2022 GDP growth (%)



Date sampled: 05/07/2022
Source: Investec Wealth & Investment, Bloomberg

The US market is not yet cheap

Even after the recent pullback, we do not see the US market as cheap. Our dividend-based model shows the US market to be about 30% overvalued. The HOLT-based implied discount for the US market is still low. The forward P/E of the US market on the other hand is near 16, not far off its 15-year median, implying a market that is around fair value.

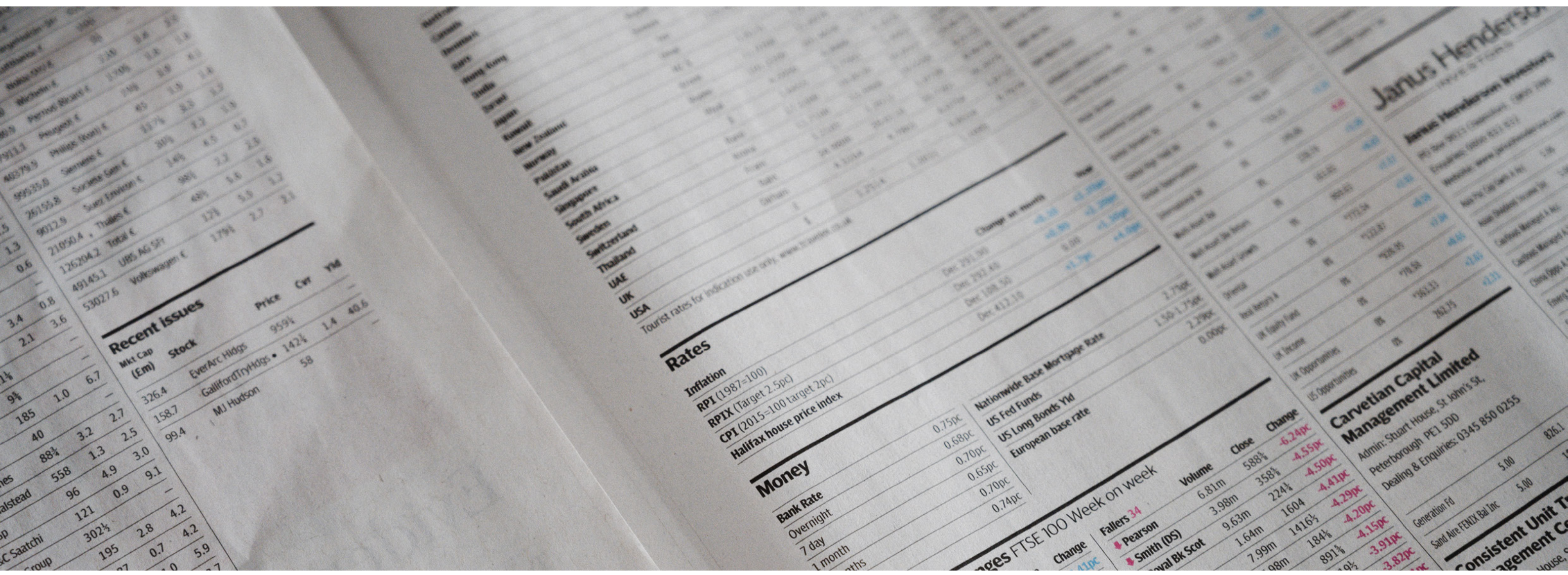
The difference between dividend-based valuation models and earnings-based models can be explained by near record low payout ratios for US firms.

The rest of the world looks more attractive

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

Pockets of value are appearing

A number of asset classes now offer a significant margin of safety e.g. high yield credit. While the opportunity set is still limited and not sufficient reason to increase the overall risk score, there are opportunities to selectively increase weights in a selection of asset classes while keeping the overall risk allocation negative.



The US housing market is slowing

Mortgage applications have rolled over and listing prices have started to decline as mortgage rates have reached decade highs. US house prices are still up over 10% year-on-year and have not yet declined month-on-month but there are some concerning clouds on the horizon.

Commodity prices have pulled back meaningfully

As concerns around the outlook for global growth have mounted, commodity prices have rolled over aggressively. It is interesting that even while pricing in a meaningful probability of a US recession in the next 12 months, commodity prices are still well above pre-covid levels, suggesting that there is still long-term structural support for commodity prices, likely stemming from elevated demand due to the global energy transition.

US dollar to weaken

Current market volatility has seen a flight to safety, leading to US dollar strength off already strong levels. As inflation rolls over and the fed softens its tone, we expect the US dollar to weaken relative to other currencies.

Climate change and government/private sector responses will lead to higher inflation over the long run. The energy transition is going to be very metal-intensive, while mining companies are showing an unusual commitment to supply discipline. The net result is that the potential for sustained higher commodity prices and ultimately structurally higher inflation has increased. In addition, ESG investing itself will have real world consequences and likely lead to larger asset class/sectoral dispersion.

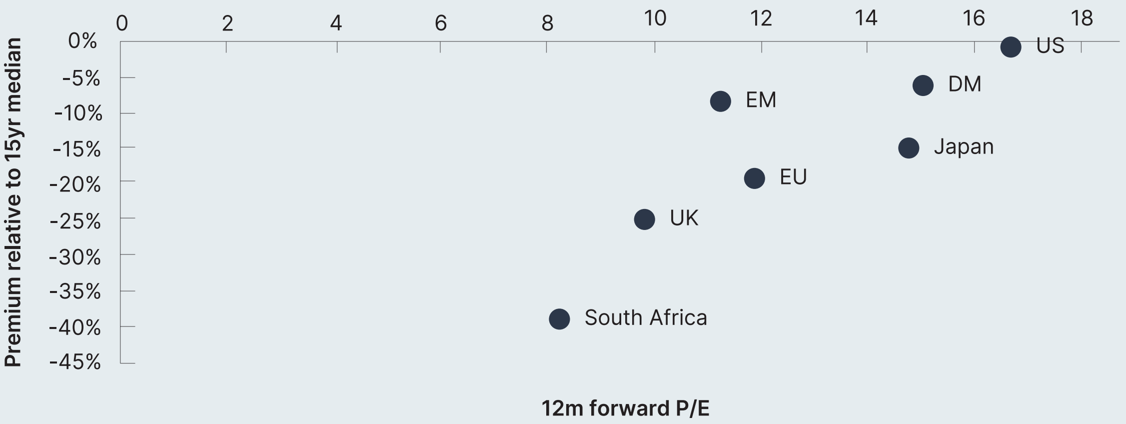
"While US equities have declined by more than 20%, they do not yet screen as attractive, based on our model"

Explaining our valuation

We believe that a dividend discount model is the best way to look at stock markets, since the growth in dividends is ultimately an impartial guide to the growth in normalised profits.
Our most important valuation touchstone for equities is therefore a dividend discount model for developed markets. While US equities have declined by more than 20%, they do not yet screen as attractive, based on our model. Our model-based estimate of the fair value dividend yield of the S&P 500 is around 2.3% vs the current 1.7%. Emerging market equities now screen as cheap.

Forward P/Es show a different picture, however. The 12-month forward P/E for the US is slightly below the 15-year median while forward P/Es for most other regions are well below 15-year median.

Valuation relative to peers and history



Date sampled: 05/07/2022
Source: Investec Wealth & Investment, Bloomberg

We estimate that there are more cons than pros to global markets at this point and remain risk off.

GLOBAL WEALTH AND INVESTMENT VIEW

SA market view and asset allocation – economic growth to continue to surprise on the upside

Overview

Last year the SA economy grew at 4.9%, which was 2.1% above the forecast of 18 months before. Q1 saw the SA economy materially surprise on the upside too, at 1.9% vs the consensus of 1.2%. Even if the SA economy does not grow at all for the reminder of the year, by our calculation the IMF, SA Reserve Bank (SARB) and consensus will all have to materially upwardly revise their SA GDP growth forecasts by the end of the year. This in an environment where nearly every other country across the globe is seeing material downward revisions to GP growth forecasts.

> "Even if the SA economy does not grow at all for the reminder of the year, by our calculation the IMF, SA Reserve Bank (SARB) and consensus will all have to materially upwardly revise their SA GDP growth forecasts"

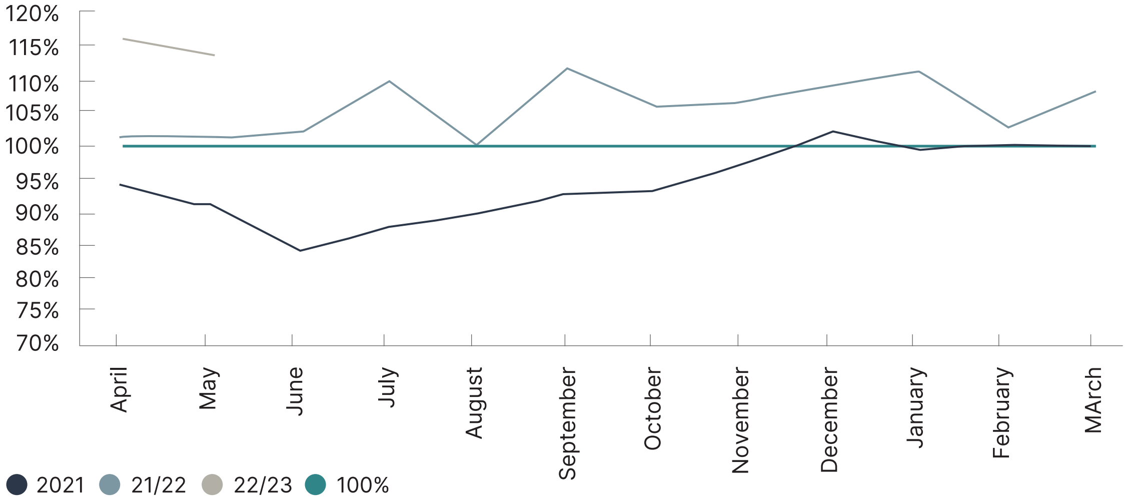
SA inflation to surprise on the upside over the coming six months but surprise on the downside over the coming decade.

By our estimate, the consensus and SARB forecasts for the coming year do not fully account for the recent fuel price increase nor the large increase expected at the beginning of July. As a result, we expect short-term inflation forecasts will be revised up over the coming two to three months. However, the bond market is pricing inflation to be above 8% five to 10 years out, which we consider to be too high. The net result is that we expect both short-term expectations to increase and breakeven inflation expectations to come in. This leads to a clear preference for nominal bonds over inflation linkers, despite short term increases in inflation.

SA consumer incomes are growing strongly

Employee tax receipts were up 13% year-on-year for April and May and are up 15% relative to 2019 levels. Formal sector incomes appear to be growing strongly.

Monthly employee tax relative to 2019



Date sampled: 01/07/2022

Source: Investec Wealth & Investment, National Treasury

That's not to say that SA consumers are doing well across the board. Incomes at the very low end are linked to grants and only increase once a year. Inflation at the low end has surged to over 8.5% while inflation at the top end is around 6.5%. Given that income is fixed at the short end until the next state Budget and costs have surged, with little savings buffer it presumably means low-end discretionary expenditure will take a sizeable knock.

SARB to hike less aggressively than currently priced in

The forward rate agreement (FRA) market is currently pricing in 11 hikes of 25bps (0.25 of a percentage point) each over the coming year. While we expect that the SARB will raise both inflation and growth forecasts over the coming few months, we do not expect that it will hike anywhere nearly as aggressively as is currently priced in. Our base case is 125bps worth of increases over the coming 12 months.

> " While we expect that the SARB will raise both inflation and growth forecasts over the coming few months, we do not expect that it will hike anywhere nearly as aggressively as is currently priced in"

Eskom risk remains elevated

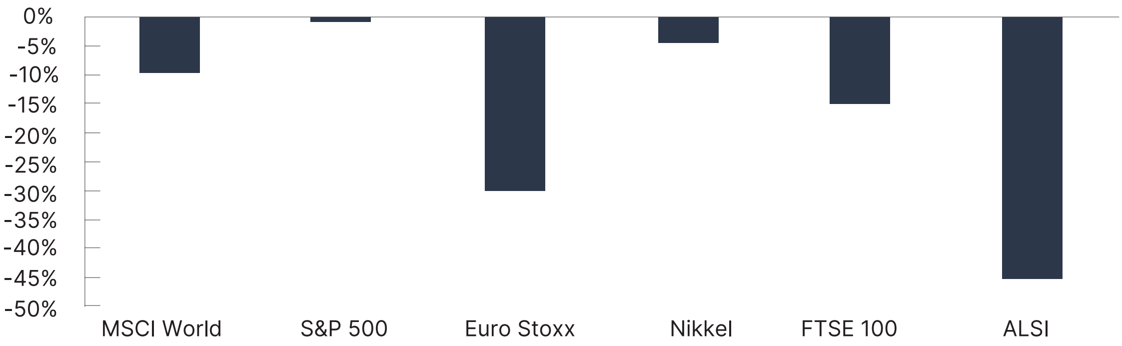
Even under Eskom's base case, SA is likely to experience regular loadshedding over at least the coming year. While companies have found ways to cope with load shedding, either through generators or solar, this comes at a cost and Eskom remains a binding constraint on growth in SA. We do not expect this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

> "Even under Eskom's base case, SA is likely to experience regular loadshedding over at least the coming year"

SA equities and bonds are cheap

The SA equity market is on a forward P/E of just over 8, half of the forward P/E for the US market. The trailing P/E is at a 45% discount to the 10-year median vs a 10% discount for aggregate developed markets.

P/E relative to 10yr median



Date sampled: 28/06/2022
Source: Investec Wealth & Investment, Bloomberg

SA bonds offer a meaningful margin of safety too. The slope of the yield curve is abnormally steep, both relative to peers and by historical standards. By our calculation, even if the 10-year bond yield moves up by 100bps, the SA 10-year government bond will provide a return similar to cash over the coming year. However, we expect the SA 10-year bond yield to decline over the coming year, leading to an expected return of 10% to 15% for the SA 10-year bond over the coming 12 months.

Overview of the different asset classes:

The committee has increased the SA risk score to 1. Both SA bonds and SA equities receive an overweight allocation.

SA equities: Screen cheap, remain overweight SA resource counters as our favoured sector.

SA bonds: Screen cheap, with support from continuingly strong government revenue and the prospect of lower global bond yields. Overweight long-dated nominals.

Cash: Rates still low relative to peers and in an absolute sense, we expect the SARB to hike by 125bps over the coming year.

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

Gold: Still overweight but looking to reduce and switch into US cash.

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	Q2 2022	Q3 2022	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	-	N	Global bond yields have picked up enough to justify a neutral position.
Global Cash	++	++	Overweight as insurance policy.
Emerging Markets	-	N	Emerging market equities screen as cheap value, in contrast to developed market 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	Q2 2022	Q3 2022	COMMENTS
SA Equity	+	+	SA equity market cheap. Forward multiple is roughly half that of the US. SA economy to surprise on upside.
SA Fixed Income	+	+	Still significant margin of safety in SA debt in our view. Government revenue likely to be above forecast again.
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.
$/R (+ for ZAR strength)	N	N	Rand trading around fair value in our view. Strong commodity prices to offset effects of higher rates in US.
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	Q2 2022	Q3 2022	COMMENTS
Global Plays	-	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. SA consumer spending likely to surprise on the upside too.
Small/Midcap	+	+	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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