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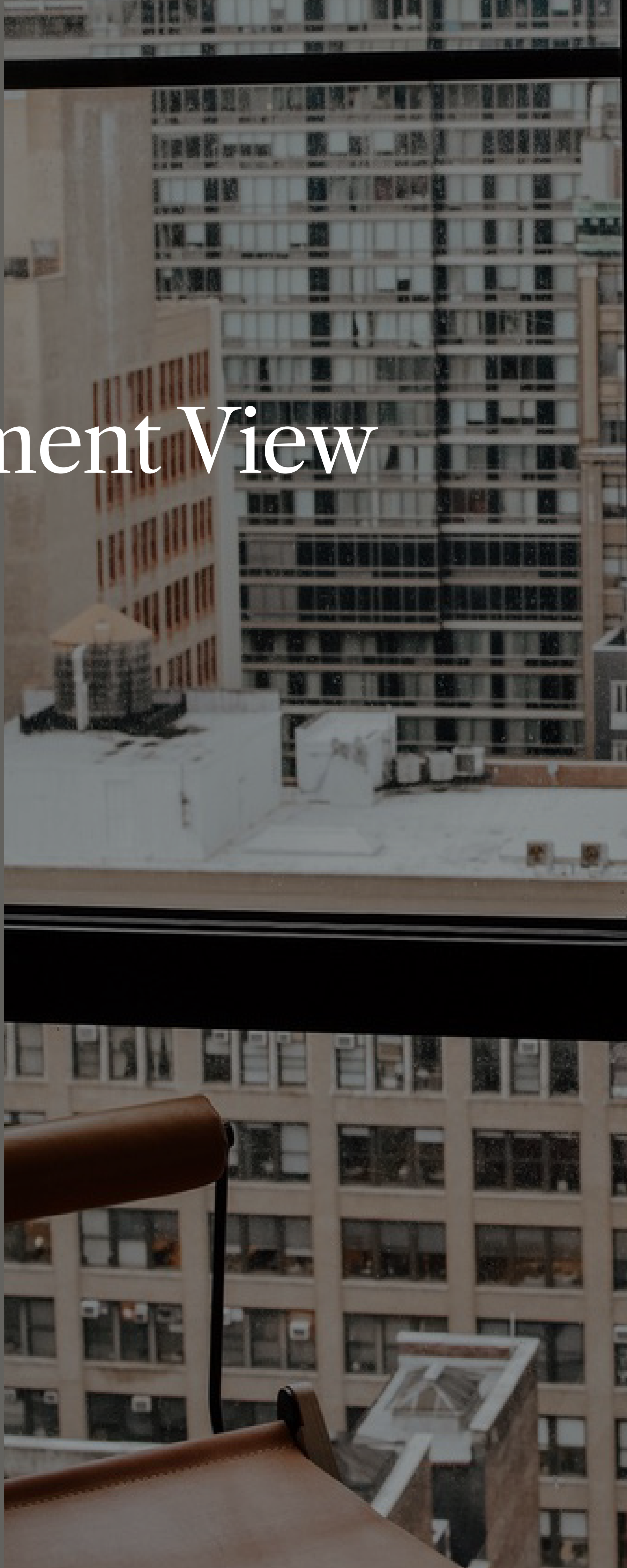
OUT OF THE ORDINARY

Global Investment View

Q2 2022



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Central banks on the back foot

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

Chief Investment Strategist,
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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 risk budget score (-0.5 on a scale of +3 to -3)

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

Significantly higher-than-expected inflation has put developed market central banks on the back foot. The US Federal Reserve (Fed) has clearly signaled that it will be hiking through the year and will simultaneously be reducing the size of its balance sheet. The European Central Bank (ECB) has also adopted a hawkish tone. The war in Ukraine has led to a spike in commodity prices, especially energy commodities, putting further upward pressure on short-term inflation and leading to reduced global growth forecasts. Despite concerns about central bank tightening and declining growth expectations, the US equity market is on a forward price/earnings (P/E) ratio of 19, a 20% premium to the 15-year average.

Equities outside of the US offer more value, but given the weight of the US market in the global equity universe, we remain underweight global equities. Developed market government bond yields have recently increased, but not to a level that would convince us to go overweight.

SA asset classes, in contrast, stand out as cheap. The local equity market trades at a near 50% discount to the US market, with earnings growth expected to be above 15% over the coming 12 months. Local bonds offer returns meaningfully above inflation. In addition, SA assets have the tailwind of much higher global commodity prices.

The rise in commodity prices stemming from the Russian invasion of Ukraine will take the edge off global growth, but we do not think it will be sufficient to lead to a recession in either Europe or the US in the short term

Key highlights of our positioning:

Covid-19 is now a regional problem

Regional flare-ups of Covid-19 infections are likely over the year ahead, and in some cases these will see localised shutdowns and potential further disruption to global supply chains. However, we do not consider Covid-19 at this point to be a threat to the global economy and further waves will likely remain regional or not fatal enough to see widespread shutdowns.

The current cycle has between one and three years to run

The rise in commodity prices stemming from the Russian invasion of Ukraine will take the edge off global growth, but we do not think it will be sufficient to lead to a recession in either Europe or the US in the short term.

Higher food prices will likely lead to protests in emerging markets and the possibility of government support in one way or another. As at mid-March, the consensus forecast was for global growth of 4% this year, but we can expect this to be revised down over the coming months. While our base case is that the conflict will only marginally reduce global growth, there is a chance that the conflict escalates, with direct intervention from current non-participants leading to a material slowdown in global activity.

CONSENSUS GDP FORECASTS	20	21	22	23
USA	-3.5	5.7	3.6	2.4
Japan	-5.1	1.7	2.8	1.7
EU	-6.8	5.2	3.85	2.5
Germany	-5.3	2.8	3.5	2.7
France	-8.3	7	3.6	2.2
Italy	-8.9	6.3	4	2.1
Spain	-11.4	4.8	5.5	3.5
UK	-10.1	7.2	4.1	2.1
China	2.3	8.1	5.18	5.2
South Africa	-7.2	4.8	1.9	1.8
DM	-4.92	5.21	3.6	2.42
EM	-0.62	6.51	4.91	4.74
World	-3.75	5.8	4	3.5

Date sampled: 11/03/2022
Source: Bloomberg, Investec Wealth & Investment

The risks to inflation over the short term

Russia is a key exporter for a number of commodities and they have each rallied meaningfully year-to-date. We can expect PPI prints for March and April to reflect materially higher energy prices, in Europe in particular. However, there is a large amount of extra oil capacity globally and current prices provide a material incentive to increase production.

As a result, we do not expect the oil price to remain extremely elevated for long. The renewed shift away from hydrocarbons in Europe will provide long-term support for industrial metals. All told, we can expect PPI and CPI prints to continue to increase over the next two months before starting to retrace.

The market is already pricing in an aggressive response from the Fed

The market is currently pricing in seven hikes of 25bp (0.25 of a percentage point) from the Fed over the year ahead, consistent with the Fed's latest dot plot. There is the possibility that developed market central banks are not fully able to estimate where the neutral interest rates is at this point and they will hike until they find it. However, given that growth is slowing and the newest threat to inflation is from further supply shocks, we think that the risk now lies with short-term interest rates surprising on the downside.

Developed market central bank balance sheet reduction still a material risk

The Fed has indicated that it is likely to reduce the size of its balance sheet fairly shortly after the first hike and the drawdown will be steeper than before. The withdrawal of liquidity from the market will likely provide a strong headwind to markets and there is a chance that the Fed will push on regardless of the market reaction.

Developed market long bond yields set to increase

Given rising inflation expectations and declining bond purchases from the Fed, we expect the US long bond yield to remain over 2% over the coming 18 months. The prospect of low/negative returns for both global equities and bonds implies low returns for balanced funds in general and there are few alternatives for generating significant returns. While we expect US yields to tick up, we do not expect the US 10-year bond yield to get to 3% anytime soon – the Fed is unlikely to allow such a rapid move, given the impact it will have on US government finances.

Given rising inflation expectations and declining bond purchases from the Fed, we expect the US long bond yield to remain over 2% over the coming 18 months

Company guidance is more negative

There has been a material increase in negative company guidance (that is, guiding below the consensus forecast) in the US as companies increasingly recognise the impact of supply chain disruptions on earnings. In addition, rising costs will likely put pressure on what are still near record margins for a number of sectors in the US. We can expect sell-side forecasts to shortly take these factors into account.

Valuations are stretched in the US

The S&P 500 is trading at 25% above our estimate of fair value (based on dividends and the prevailing US long bond yield). In addition, forward P/E, price-to-book and implied discount rates all show the US market to be expensive. While materially down year-to-date, the US market is up since Russia invaded Ukraine, despite increased uncertainty with regards to both global growth and inflation. Despite the year-to-date pullback, there is little margin of safety in US equities at this point. For the first time in two years, emerging market equities screen as fair value. Some forms of credit are starting to screen as cheap.

Opportunities beneath the surface

While the S&P 500 continues to screen as expensive, there are a number of subsectors in the US that look attractive and a number of benchmark indices outside of the US look reasonably priced or cheap. The prospect of rising long bond yields in an environment of still decent growth implies opportunities for low duration, cyclical assets to outperform.

The net result is risk assets offer little margin of safety and tighter monetary policy is on the horizon. We think it is time to start taking risk off the table.

> For the first time in two years, emerging market equities screen as fair value.

GLOBAL WEALTH AND INVESTMENT VIEW

SA market view and asset allocation – Higher commodity prices to carry the SA economy over the next five years

Overview

The Asset Allocation Committee has kept its SA risk score at 0.5. Both SA bonds and SA equities receive an overweight allocation.

Key themes for the quarter:

The SA economy is set to surprise on the upside over the coming five years. SA's GDP per capita has been in a trend decline relative to its peers for over 20 years. In the late 1990s, SA GDP per capita was in the top 40% of countries across the globe and in 2021 it was in the top 50%. The International Monetary Fund (IMF) expects SA's position to fall another 10% over the coming three years. This would be a decline unlike anything seen post democracy.

We think these expectations are too low – either global GDP growth forecasts are too high or expectations for the SA economy are too low. Either way, we do not expect the SA economy to deteriorate relative to peers as rapidly as expected by the IMF.

Part of the reason we expect the SA economy to do better than the IMF expects is the knock-on consequences of higher commodity prices. Higher commodity prices imply greater tax revenue for the state – which in turn will potentially lead to tax cuts. Higher commodity prices also provide support for the rand, reducing a need to hike rates.

> Higher commodity prices imply greater tax revenue for the state – which in turn will potentially lead to tax cuts. Higher commodity prices also provide support for the rand, reducing need to hike rates.

SA interest rates to surprise on the downside

The forward rate agreement (FRA) market is currently pricing the repo rate to be increased by 25bps (0.25 of a percentage point) on nine occasions over the coming year. While we do expect inflation to surprise on the upside over the coming year, we do not see the SA Reserve Bank hiking by 225bps (2.25 percentage points) within 12 months. We expect the repo rate to go up four or five times over the coming year.

SA bonds to outperform cash over the coming year

The margin of safety in SA government debt is very large at this point. Even if the long bond yield moves up by 100bps (one percentage point) over the year ahead, which is not our expectation, we expect that SA bonds will perform in line with cash. Should SA government bond yields decline we expect that SA bonds will generate mid teen returns.

SA equity market is cheap

SA equities are on a forward P/E of less than 10, with 16% earnings growth. We think there is scope for both a rerating and an acceleration in earnings growth.

The margin of safety in SA government debt is very large at this point.

Overview of the different asset classes:

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

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

SA equities are on a forward P/E of less than 10, with 16% earnings growth.

Bonds: Screen cheap but rising US yields are likely to see SA yields remain elevated.

Cash: Cash rates are currently low in both nominal and real terms in SA, so 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. In addition, rapid money supply growth in developed markets may lead to inflation down the line.

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	Q1 2022	Q2 2022	COMMENTS
Global Equity	-	-	GISG score negative. Market screens as expensive with monetary policy tightening to come. Still above trend GDP and earnings growth though.
Global Fixed Income	--	-	Bond yields have picked up but not enough to justify a neutral position.
Global Cash	++	++	Overweight as insurance policy.
Emerging Markets	-	-	EM equities screen as fair value, in contrast to DM equities.
Global Property	N	-	Valuation still elevated relative to long term average. Reducing weight to allow for marginally more FI exposure.
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	Q1 2022	Q2 2022	COMMENTS
SA Equity	+	+	SA equity market cheap. Forward multiple is roughly half that of the US. Upward earnings revisions likely.
SA Fixed Income	+	+	Still significant margin of safety in SA debt in our view. Govt. 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	ZAR trading a bit stronger than 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.

SECTORAL/THEMATIC POSITIONING	Q1 2022	Q2 2022	COMMENTS
Global Plays	-	-	Underweight, preference for overweight in SA play and commodity stocks.
Commodities	+	+	We expect commodity prices to continue to surprise on the upside. Resources cheap in our view.
Precious Metals	+	+	Precious metal producers offer a hedge against SA risk and leverage to a global recovery and weak ZAR.
SA Plays	+	+	Precious metal producers offer a hedge against SA risk and leverage to a global recovery and weak ZAR.
Small/Midcap	+	+	Valuations still attractive and investor appetite starting to increase.

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

GLOBAL WEALTH AND INVESTMENT VIEW

Why global inflation may surprise on the downside

By Chris Holdsworth

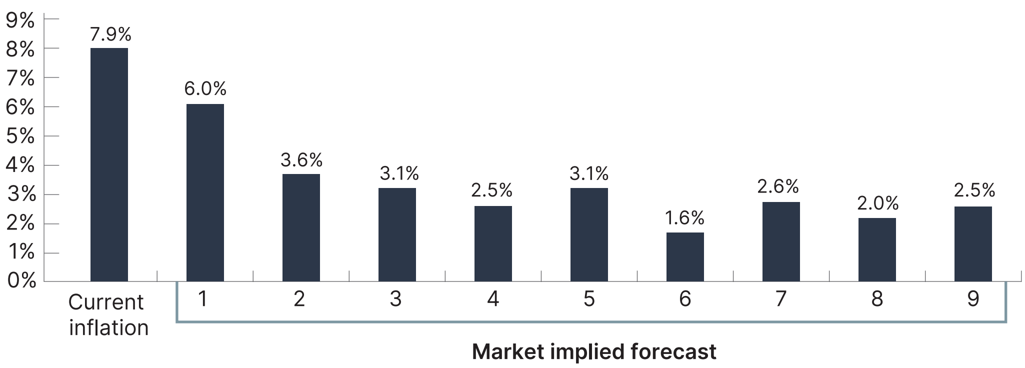
From shipping costs to home rental and used car prices, signs are emerging that global inflation may be close to its peak.

Rampant post-covid demand in developed markets, fuelled by stimulus checks and ultra-low interest rates, combined with supply chains that have not yet fully untangled, have led to a surge in inflation across the globe. Median inflation for the 50 largest economies was 5.7% in February, the highest reading in at least 20 years. US inflation is around 8%, the highest reading in 40 years and German PPI inflation is 25%.

The latest spike in energy prices, as a result of the Russian invasion of Ukraine, has in many senses been the final straw – the market has started to increase long-term inflation expectations.

The 10-year breakeven rate, the bond market's expectation for average inflation over the coming decade, has recently breached 3% in the US for the first time on record. The market is furthermore pricing in US inflation remaining above 2% for at least the next five years.

US inflation and market forecast for future years based on breakevents

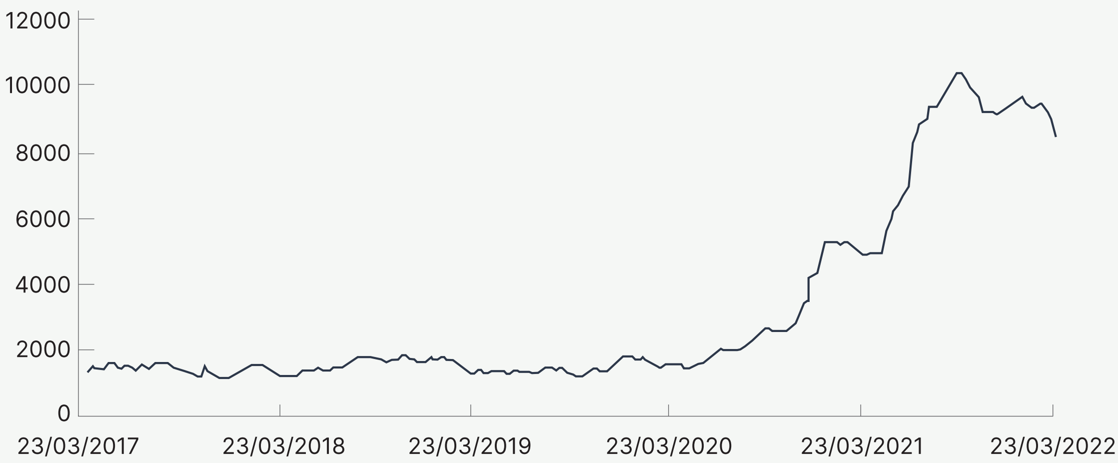


Date sampled: 29/03/2022
Source: Investec Wealth & Investmnet, Bloomberg

At the very point at which long term inflation expectations are starting to be ratcheted up however, there are now signs of disinflationary pressures building. One of the key drivers of the initial spike in PPI inflation, global shipping, is already starting to recede.

Global shipping costs are currently 18% off their peak. If they stay at these levels, then in six months' time they will be down 18% year-on-year. In reality, shipping rates are likely to continue to decline, as US retailers have successfully rebuilt their inventories to pre-covid levels, which should provide some breathing room for shipping companies.

World container index ($ cost of moving 40ft container)



Date sampled: 29/03/2022
Source: Investec Wealth & Investmnet, Bloomberg

Another key driver of the initial spike in US inflation, used car prices, is already heading down. February saw the second consecutive month of declines in US car prices and used car prices are now back to where they were in October last year.

> February saw the second consecutive month of declines in US car prices and used car prices are now back to where they were in October last year.

If the conflict in Ukraine comes to an end relatively soon, then we can expect energy prices to recede too. However even if the conflict persists, the marginal cost of production for new oil in the US is less than US$50/barrel. It is quite likely that global oil supply will increase in response to higher prices and will ultimately lead to lower energy prices.

> Even if the conflict persists, the marginal cost of production for new oil in the US is less than US$50/barrel.

Rent prices have been escalating aggressively in the US – the Zillow rent price index is up 15% year-on-year. But there is a near record number of homes under construction in the US and when this supply hits the market over the coming six months, it's hard to see how rent growth will remain as strong as it currently is.

That's not to say US inflation will collapse. Food price inflation is likely to remain sticky as a result of disruptions to global fertiliser markets and there are other components of the CPI basket that will only drift down, rather than fall sharply. However, we are probably not far away form the peak in US inflation and it may well decline more rapidly than expected.

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