Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q1 2024 – All eyes on central banks

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

The Global Investment View distils the thinking of the Global Investment Strategy Group (GISG) that brings together the insights of Investec Wealth & Investment 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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Chris Holdsworth, CFA

Chief Investment Strategist,
Investec Wealth & Investment, SA

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, covering investment strategy for six years and heading up the research team for two years. He is also Chair of the Global Investment Strategy Group (GISG).

Achieving financial fulfilment

It's possible to find financial contentment during times of uncertainty – provided you plan properly. We look at the key elements in getting to a place of fulfilment.

As we step into the new year, we pause and reflect. 2023 was a challenging year for humanity in which the specter of escalating war loomed and inflation peaked. We start the new year with many conflicts across the globe remaining unresolved. War can be destabilising and make us feel anxious and uncertain, and while it is a reminder to be mindful of sovereign risk, it also illuminates our interconnectivity.

The year ahead is likely to be one of change. According to the World Economic Forum, more than 50 countries, including the United States, the United Kingdom and South Africa are intending to hold national elections in 2024. That's more than two billion people going to the polls.

It has been three years since the pandemic, and during this time, our data suggests that flexible and remote work has become normalised and is likely to remain a permanent fixture. As a collective, we are moving beyond the rigidity of the eight-hour, office-bound workday implemented by Henry Ford in the 1920s, as well as the forced retirement age of 70 established by Bismarck in 1881 and later amended to 65 by Franklin D. Roosevelt. The world has become more global. Cape Town is teeming with mostly European global and entrepreneurial digital nomads. Families are now spread across the globe, with more complex estate planning needs to be met, especially when it comes to succession.

Artificial intelligence (AI) has gone from fringe to mainstream. It is a huge disruptor, with both challenges and opportunity for innovation and investment. With the influx of consumer generative AI programmes like Google's Bard and OpenAI's ChatGPT, the generative AI market is poised to explode, growing to $1.3 trillion over the next 10 years from a market size of just $40 billion in 2022, according to a new report by Bloomberg Intelligence (BI).

2022 challenged the traditional model of investing, as both equities and bonds suffered as inflation spiked. Our clients are able to diversify via structured products, alternatives and private equity, offering them access to some truly special, non-correlated investment opportunities.

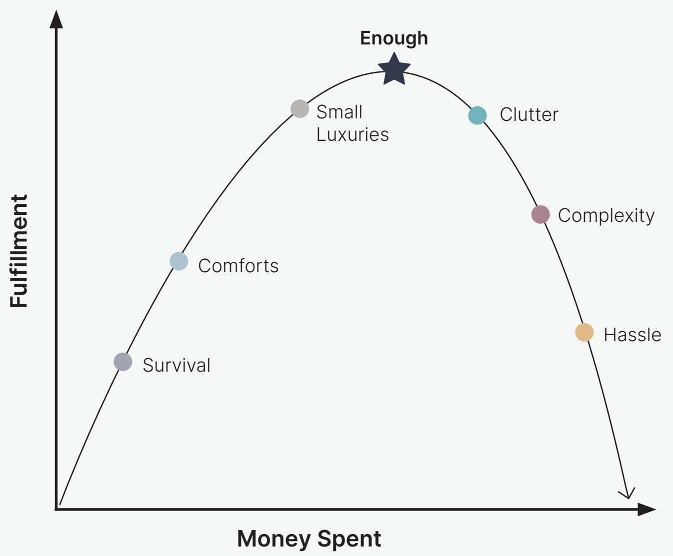
Diversification is one of the principal tools of investing, which we can use to ground ourselves during these times of uncertainty, as well as providing appropriate asset allocation and staying invested for the long term. While interest rates across developed markets have been negative for the last few years and last year saw the return to positive cash rates, this has not diminished the importance of staying invested. For example, if you had exited the market last year or remained invested in cash you would have missed the late rally that provided two years of cash returns in two months. Market returns usually occur in a series of hard-to-time bursts.

Volatility caused by external circumstances can create inner turmoil. We can address this by embracing behavioural finance and by planning appropriately for our lives, so we don't panic when we feel anxious.

Planning properly for our lives to meet our short-term obligations, possible opportunities and income needs, means we should have sufficient funds in cash and near cash to provide for these. This provides a buffer to take on more risk with other assets and the opportunity for growth. The ability to hold these growth assets for a longer period without needing to draw from them to cover liquidity needs, allows us the time to weather periods of market volatility with these assets. These growth assets in turn provide for future income and liquidity needs that may arise in our lifetime. Other investments can be positioned for the much longer term, where the longer time frame affords us the ability to hold illiquid or higher risk/reward investments or special investment opportunities, which could be used in the fullness of time for our legacy and future generations.

Another psychological frame is being aware of the so-called fulfilment curve. The graph below shows the fulfilment curve that was introduced in "Your money or your life" by Vicki Robin and expanded on in the chapter "Never Enough" by Morgan Housel in his book "The Psychology of Money". It depicts fulfillment on the vertical access and money spent on the horizontal axis.

The Fulfilment Curve



From: Your Money or Your Life, Penguin Books, 2008

The premise of the curve is that, at the survival level, we get a relatively high amount of fulfilment for money spent or resources consumed. The difference between having food or not, between having a roof over your head or not, in terms of fulfilment is vast. At the comforts level, for example, at the time of your first toy, music player, or bicycle, fulfillment is still going up. This pattern gets reinforced and as we mature, we internalise the idea that "material things from outside contribute to my needs and bring me fulfilment".

However, at the luxuries stage the curve begins to flatten out. It takes a lot more money spent or resources consumed to get a little more fulfilment. The extra TV, car or house does not bring us as much fulfilment as the first one. In economics this is called the "The Law of Diminishing Returns." The peak of the fulfilment curve is called "enough". It is a plateau, a point where more money spent and more things acquired will not bring fulfilment. In fact, the opposite is true. It creates clutter, complexity and hassle. "Enoughness" is the place of maximum fulfilment and happiness in exchange for money spent or material consumption.

Being aware that more material consumption or money spent does not bring additional happiness or fulfilment after a certain point is also useful, being mindful that increasing sustainability concerns globally require us to consider not just economic risks and returns, but sustainability-adjusted risk and return. We are all stakeholders of the earth, and we need to be good stewards.

However, happiness can be increased by things other than material consumption or money spent. For example, connection with ourselves, with others and nature. Finding our own individual purpose and living a life in accordance with our values and passions. By improving the lives of others, leaving a meaningful legacy, and spending time with loved ones, we can have interesting experiences and conversations.

Many of our clients have wealth, assets and affairs that can create complexity and we continually seek to assist them to find financial contentment and operate from the place of fulfillment. As our clients' businesses and lives become more global, so to do their families. Having children and property in multiple jurisdictions results in complexity in terms of tax and estate planning. We continue to invest in our global specialist tax and fiduciary team to help our clients navigate this global planning and create more simplicity in their lives.

We also invest in our global footprint to assist our clients with global wealth management and to mitigate sovereign risk. In addition to established footprints in the United Kingdom and Mauritius, we have invested this year in creating a home for our global clients at Investec in Switzerland, a neutral, triple A-rated sovereign state. From here we offer our clients a fully-fledged Swiss suite of wealth and banking services.

Last year, in addition to winning the FT Global Private Banking Awards, Investec won the Best Private Bank and Wealth Manager in South Africa for the 11th year running, and for the second year we were also awarded the Best Private Bank and Wealth Manager in Africa for Philanthropy services. We offer strategic philanthropy services for our clients and their families to establish and manage their charitable foundations, enabling the distribution of funds to create meaningful societal impact now whilst preserving their capital for future growth / change. Last year we distributed R53million across 83 beneficiary organisations as follows: 45% Education, 27% Welfare & Humanitarian, 16% Social Justice and 12% Healthcare. For us, a reflection of our desire to help our clients expand their enduring worth beyond their individual live span.

As we close, it is worth noting this year we won two raging bull awards for our funds: the best South African General Equity Fund and the best Global Best (FSCA-Approved) Offshore Global Asset Allocation Fund on a Risk-Adjusted Basis. We are proud to be recognised for both our local and global investment management capability and will continue to stive to make our clients excellent risk, and sustainability risk adjusted, returns. As you embark on the year ahead, we extend our wishes for a peaceful and abundant journey. May we continue to support you in living a life that aligns with your unique purpose, helping you plan for your personal needs and values, and assisting you in finding financial fulfilment amidst an ever-changing world.

Marc Romberg and Ali Nortier

Joint Heads of Wealth Management

The GISG reduced its global risk budget score (-1 on a scale of +3 to -3), while the SA risk score has been maintained at +0.5

Increase Risk Allocation

Neutral

-3	-2	-1	0	1	2	3
Equivalent to 15% underweight equities		Global is here	South Africa is here			Equivalent to 15% overweight equities

Summary

The US economy continues to surprise on the upside and US companies remain remarkably profitable. While GDP growth is set to slow, it is not impossible that margins remain high, providing some support for US equities. Inflation is set to continue to decline and we expect it to surprise on the downside – allowing for accelerated cuts by the Fed.

Acting against these tailwinds are tightening lending standards, weakening credit growth and the first signs of weakness in the US labour market. All of these point to the prospect of materially weaker growth over the year ahead. Excess savings have been dwindling too. Given current levels of indebtedness, it is not clear if the US government will be able to provide a sizeable fiscal package should growth slowdown.

Growth in the rest of the globe is set to slowdown, but at least equities in the rest of world offer a sizeable margin of safety. Fixed income screens as attractive too.

US equities still screen as expensive. The premium over Europe is near a record high whether one uses P/B, EV/EBITDA or P/E ratios*. Credit spreads are also near record lows. We find these hard to reconcile against the economic outlook and have reduced our risk score to -1.

We see more value in South Africa – where rate cuts are also not too far off, in our view. The election this year may imply reduced fiscal constraint from the SA government, but even so, the margin of safety in South African debt is sufficiently large for South African bonds to be our preferred asset class. The prospect of reduced loadshedding this year, and rate cuts, leads us to retain our overweight in SA Inc shares. Our South African risk score is at +0.5.

*Price to book; enterprise value to earnings before interest, tax depreciation and amortisation; price to earnings

Rationale:

Markets have recently been strong. The back end of last year saw extremely strong performance from global equities and fixed income and January returns have been good too. Over the past 12 months, global equities are up around 20%. This has occurred in part due to a material downward shift in interest rate expectations while growth in the US has proven to be resilient.

Increased uncertainty. This year sees elections in over 50 countries. The US, UK, and India are among the countries that head to the polls. There is a non-negligible risk of further widespread government fiscal deterioration as incumbents spend to remain in power. While this should provide a boost to spending, the outlook for policy from next year in many countries, especially the US, is far from certain. At this point the betting market is pricing in a very tight race between Biden and Trump. Elections across the globe are reason enough to expect a volatile year.

> “This year sees elections in over 50 countries. The US, UK, and India are among the countries that head to the polls

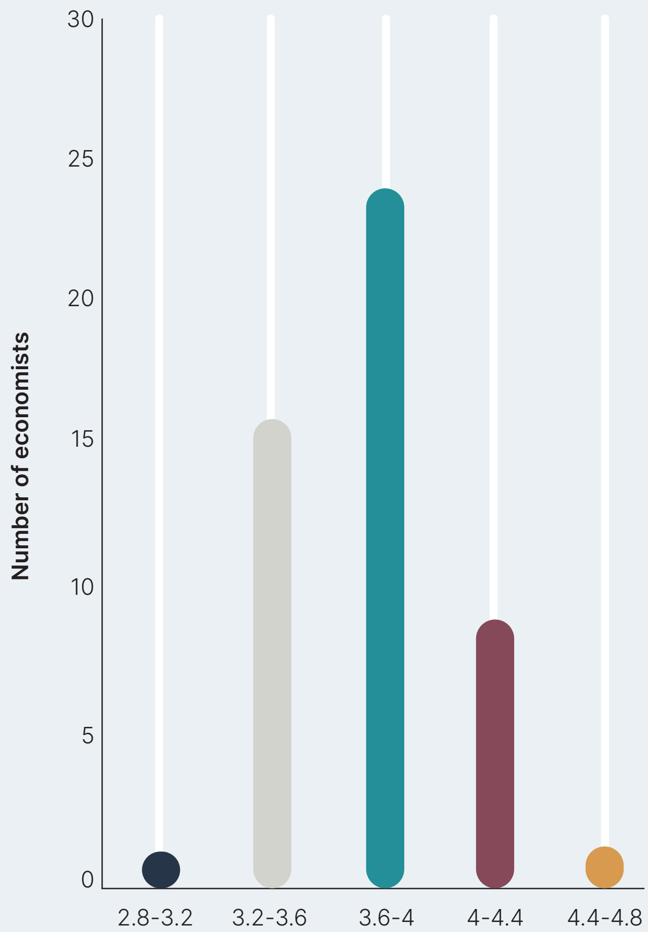
There are other reasons for uncertainty too. Here is a non-exhaustive list:

1. War in Ukraine and potential impact on agricultural and energy markets.
2. War in the Middle East - risk of spreading, with risk to energy markets.
3. Disruptions to trade through the Red Sea, with potential risk of higher inflation and disruptions to European manufacturing.
4. Reduced capacity at the Panama Canal due to a drought, with the potential risk of delays in shipping and higher shipping costs.
5. Uncertain outlook for goods price inflation given the above, and inflation more generally.
6. Uncertain interest rate outlook due to uncertain inflation outlook.
7. Uncertain growth outlook.

Elevated uncertainty is reflected in sell side forecasts. There is a particularly wide range of forecasts for where the US 10-year bond yield will end the year, where the S&P 500 will end the year and where inflation will end the year. The FOMC has expressed similar uncertainty too with regards to their own forecasts for growth and inflation.

> “Elections across the globe are reason enough to expect a volatile year

Dispersion of sell side forecasts for US 10 year bond yield at the end of 2024



Date sampled:12/01/2024
Source: Bloomberg

ALL EYES ON CENTRAL BANKS

Growth is slowing. We no longer have a US recession in the next 12 months as our base case but we, along with consensus, do expect a slowdown in US economic activity. The current consensus forecast is for US GDP growth to drop to 1.3% this year from 2.4% last year.

Europe and Japan are set to grow by less than 1%, while the UK is set to grow by all of 0.3%.

Inflation is set to slowdown. The consensus view is that US inflation will average 2.6% this year, down from 4.1% last year. We no longer expect that US inflation will surprise on the downside.

> "We no longer have a US recession in the next 12 months as our base case but we, along with consensus, do expect a slowdown in US economic activity

Consensus CPI inflation forecasts

CONSENSUS CPI FORECASTS	22	23	24	25
USA	8	4.1	2.6	2.3
Japan	2.5	3.2	2.3	1.7
EU	8.4	5.5	2.5	2.1
Germany	8.6	6.1	2.7	2.15
France	5.9	5.7	2.5	2
Italy	8.7	6	1.95	1.85
Spain	8.5	3.5	2.8	2.1
UK	9.1	7.4	3	2.05
China	2	0.4	1.4	1.75
South Africa	6.9	5.9	5	4.5
DM	8.53	5.74	3.74	2.77
EM	6.09	5.86	6.9	4.11
World	7.6	6	4.3	3.6

Date sampled: 11/01/2024
Source: Bloomberg, Investec Investment Management

ALL EYES ON CENTRAL BANKS

The outlook for Fed policy is not clear. While the market is pricing in six cuts of 0.25 percentage points (25bps) each over the year ahead there is a sizeable risk that the Fed takes a more cautious approach. Higher-than-expected rates will likely be a headwind for markets.

Excess savings are being depleted. Despite wage growth running below inflation, consumer spending remains relatively robust – suggesting dissaving on the part of US consumers. At some point in the not-too-distant future, the buffer will be eroded – at a point when US monetary policy is likely tight and potentially fiscally tight too. Tightening credit standards imply that banks are unlikely to be lending aggressively over the coming 12 months.

Fiscal pressures are building. The surge in developed market yield curves over the past two years will start to affect the fiscal position of developed market governments. Given that inflation has started to recede, the Fed and other developed market central banks will need to follow shortly, or we will see both tight fiscal and monetary policy simultaneously. Given current debt levels, it is not clear that there is space for much fiscal support should there be a material slowdown in US GDP growth.

Margins have been high – can they persist? US corporate margins have persistently surprised on the upside over the past year – resulting in earnings proving to be more resilient than expected. New technology – such as the widespread use of AI implies the possibility that margins remain high.

Earnings forecasts are still optimistic. Despite signs of an imminent slowdown in US and global growth, the consensus forecast is still for double-digit earnings growth this year. There is material risk of sizeable downgrades over the coming months even if margins remain higher than average.

Chinese data are starting to turn. Chinese exports are now up year-on-year, the three-month average of total social finance is up nearly 40% year-on-year and Chinese retail sales were up 7.4% year-on-year in December. It seems that Chinese data has started to turn. Given that Chinese inflation remains below zero, and will likely be below target for some time, further stimulus is likely.

US equities to underperform Treasuries over coming three and 18 months. The prospect of a slowdown in US GDP growth and earnings downgrades with little margin of safety in equity valuations implies significant chance of the US equity market underperforming treasuries over the short term.

The rest of the world is looking more attractive. Both earnings and dividend-based models show Europe, UK, and emerging markets to now be at or below fair value. Emerging market GDP growth will likely accelerate this year on the back of China reopening and given still low inflation in China.

South African market view and asset allocation – signs of stabilisation

We are not too far from a cut by South Africa's MPC. We expect that South African inflation will be within the Reserve Bank's target band for the next 12 months. As in the US, monetary policy is the tightest it has been in 14 years. We expect the Monetary Policy Committee (MPC) to cut by 75bps (0.75 percentage points) over the coming year.

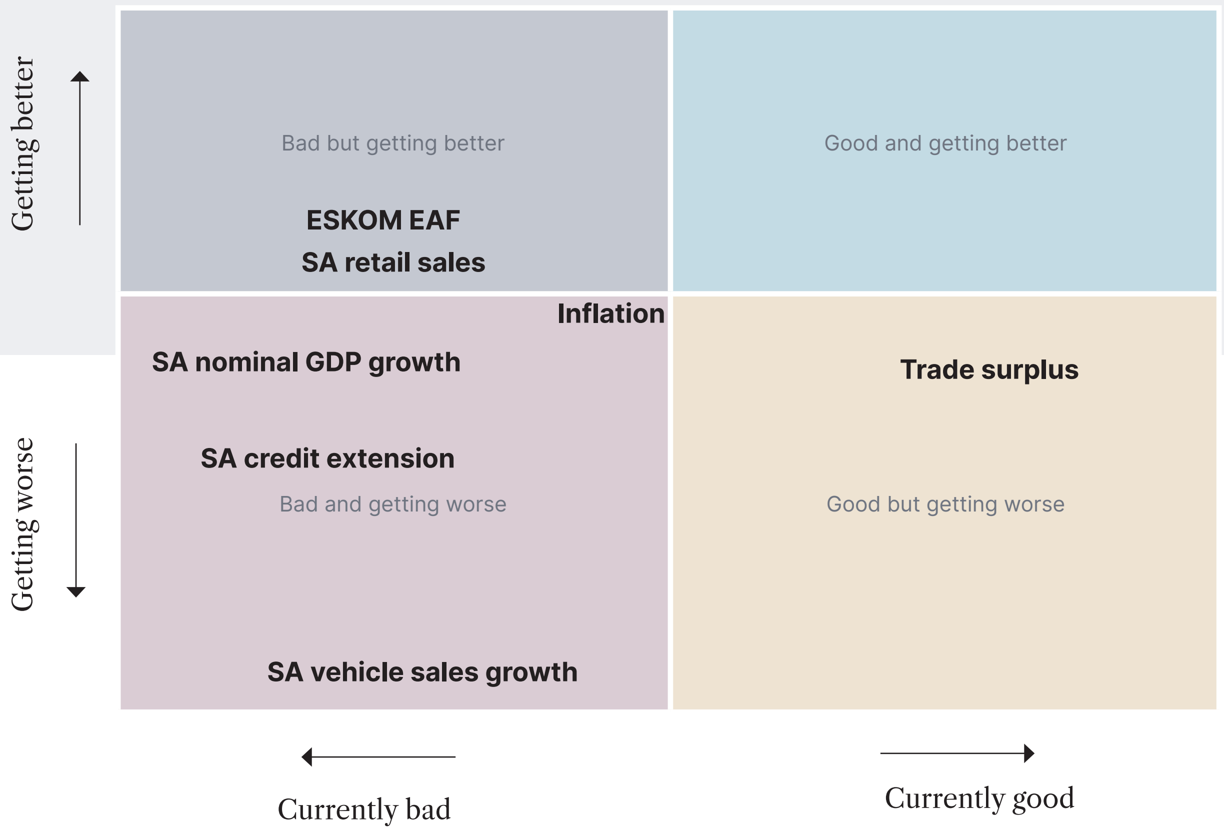
> "We expect that South African inflation will be within the Reserve Bank's target band for the next 12 months"

Signs of stabilisation at South Africa's SOEs? We have created an index of the performance of railways, ports and Eskom. There are early signs of stabilisation across state-owned enterprises (SOEs), based on the index, but we probably need a few months to be able to make a definitive call.

> "There are early signs of stabilisation across state-owned enterprises (SOEs), based on the index, but we probably need a few months to be able to make a definitive call"

The economy is currently weak but there's light at the end of the tunnel. SA economic data remains weak. Vehicle sales, retail sales, credit extension and nominal GDP growth are all still unimpressive. However, inflation has declined over the past six months, which should provide scope for rate cuts to follow shortly, providing some relief. We maintain our view that we are probably past peak loadshedding, given the scale of solar imports. As noted in our previous edition, we expect SA Inc companies to see a combination of margin expansion and higher volumes as diesel costs come down and rate cuts spur the economy.

SA macro data and changes over past 6 months



Date sampled: 22/01/2024
Source: Investec Wealth & Investment, Bloomberg

Bonds are our preferred asset class. South African government debt with a maturity of more than five years seems to attract a significant margin of safety. As the short rate comes down, we expect it will bring down the long bond yield too. The upcoming election raises the prospect that the government will temporarily be less fiscally prudent than normal, but with double digit yields we still see upside in South African government bonds. Even if government bond yields go up by 100bps (one percentage point), which is not our expectation, then by our calculation government bonds will give 5% over the year.

Equities are cheap. The South African equity market is unequivocally cheap. The trailing 12-month price/earnings ratio is trading at a 35% discount to the 10-year median. There is upside risk to earnings forecasts too, based on the improving electricity situation.

'SA Inc' our preferred sector. SA Inc shares (shares whose fortunes are tied to the performance of the South African economy) have derated materially on the back of South Africa's foreign policy stance, rising electricity costs and the weakening economic backdrop. We expect that improving electricity availability and a potential reduction in rates will see a rerating with an upside risk to our earnings forecasts.

Valuation and asset allocation:

The SA risk score has also been maintained at +0.5.

Based on our estimates, South African asset classes screen as cheap both in an absolute sense and relative to peers, compared with global assets, which screen as expensive.

Equities: Screen cheap but weak global returns are likely to be a strong headwind. We favour SA Inc. Neutral.

Bonds: Screen cheap, but with the prospect of support from lower global bond yields. South African politics likely to affect this asset class in particular.

Cash: We expect the Reserve Bank to cut rates by 50bps withing the first six months of 2024.

Property: Sufficiently cheap to justify neutral position.

Gold: Overweight but we are looking to reduce and switch into US cash or Treasuries.

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 2023	Q1 2024	COMMENTS
Global Equity	–	–	GISG score negative. Global growth set to weaken with sizeable downside risk to earnings forecasts. US market does not offer sufficient margin of safety.
Global Fixed Income	+	+	Global FI screens as attractive with US nominal bonds in particular.
Global Cash	+	+	Overweight given global uncertainty.
Emerging Markets	**N**	**N**	EM equities screen as reasonably priced, in contrast to DM equities. China rebound should provide a tailwind.
Global Property	–	–	Structural headwinds overwhelming improving valuation.
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 2023	Q1 2024	COMMENTS
SA Equity	**N**	**N**	SA equity market cheap. However global headwinds will still be strong for the foreseeable future.
SA Fixed Income	+	+	Still margin of safety in SA debt in our view. Election this year implies will likely remain cheap for a while.
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	**N**	**N**	Large discount to NAV. Hedged against increase in interest rates. Utility costs passed on to tenants.
SA Preference Shares	**N**	**N**	Valuation for aggregate sector near fair value. Opportunity in bank prefs though.
USD/ZAR (+ for ZAR strength)	+	+	USD/ZAR weaker than our estimate of fair value.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks, particularly the risk of higher than expected inflation. Also a hedge against rising geopolitical risk.

SECTORAL/THEMATIC POSITIONING	Q4 2023	Q1 2024	COMMENTS
Global Plays	**N**	**N**	Neutral. Global outlook weak but global plays offer a hedge vs SA specific risk.
Commodities	**N**	**N**	Reduced to neutral on back of weakening global growth. Strong long term support from global energy transition though.
Precious Metals	–	–	Risks to the gold price ahead, better opportunities in diversifieds and SA Inc.
SA Plays	+	+	Expected decline in diesel costs over the coming year as electricity situation improves. Expected rate cuts helpful too.
Small/Mid cap	+	+	Valuations still attractive.

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

Investec Wealth & Investment

Contact details

Mauritius
6th Floor, Dias Pier Building
Le Caudan Waterfront, Caudan Port Louis, Mauritius
Telephone: +230 207 4200
Facsimile: +230 207 4003

Switzerland
Loewenstrasse 29
8001 Zurich Switzerland
Telephone: +41 44 226 10 90
Facsimile: +41 44 226 10 10

Johannesburg
PO Box 78055, Sandton, 2146
100 Grayston Drive, Sandown, Sandton
Telephone: +27 (0) 11 286 4500
Facsimile: +27 (0) 11 286 9595

Cape Town
PO Box 4059, Cape Town, 8000
14 Dock Road, Victoria & Alfred Waterfront, Cape Town
Telephone: +27 (0) 21 416 3000
Facsimile: +27 (0) 21 416 3598

Durban
PO Box 3912, Durban, 4000
5 Richefond Circle, Ridgeside Office Park, Umhlanga
Telephone: +27 (0) 31 575 4000
Facsimile: +27 (0) 865 00 99 01

London
30 Gresham Street London EC2V 7QP United Kingdom
Telephone: +44 (0) 20 7597 1234
Facsimile: +44 (0) 20 7597 1000

Pietermaritzburg
Investec Pietermaritzburg, 48 Bush Shrike Close, Victoria Country Club Estate, Montrose, Pietermartzburg.
3201Telephone: +27 (0) 33 264 5800
Facsimile: +27 (0) 33 342 1561

Gqeberha
Waterfront Business Park, Pommern Street
Humerail Gqeberha 6001
PO Box 13434 Humewood 6013
Telephone: +27 (0) 41 396 6700
Facsimile: +27 (0) 41 582 2536

Pretoria
PO Box 35209, Menlo Park, 0102
Cnr Atterbury & Klarinet Street Menlo Park, Pretoria
Telephone: +27 (0) 12 427 8300
Facsimile: +27 (0) 12 427 8310