Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q1 2025 – A tough year ahead for global equities?

Contents

By Chris Holdsworth, Chief Investment Strategist, Investec Wealth & Investment International 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'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, Investec Wealth & Investment International

Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Investec Wealth & Investment International. 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).

02 Aligning investment with purpose

04 The GISG kept its global risk budget score at -1 on a scale of +3 to -3, while the SA risk score was maintained at 1.5 on a scale of -3 to +3

08 South African market view and asset allocation – keeping the local risk score at 1.5

11 Asset allocation positioning

FOREWORD: *Aligning investment with purpose*

2024 was a year of significant change, the biggest election year in human history, according to the United Nations. In the United States, Donald Trump has returned to office with gusto, and the United Kingdom is undergoing extraordinary changes affecting taxpayers.

In South Africa, we opted for resilience over retreat. The Government of National Unity (GNU) now better represents the population and embraces diversity of thought and experience, which has positively impacted the market. We are seeing an increase in working together. Anecdotally, a new cabinet member shared in recent business feedback that cabinet members, across parties, were sharing cell phone numbers and collaborating for the first time, which is encouraging.

Additionally, we have observed increasing integration of human intelligence with artificial intelligence (AI) and technology. AI has begun to exhibit emergent human qualities such as humour, thoughtfulness and cognitive empathy. It appears to have developed a theory of mind. We already have AI thinking partners with personalised versions of chat GPT, and these will become friends (and possibly partners) in the future.

Positively, AI is being utilised to free up time, enhance education through individualised learning, and advance medicine. However, there are negative aspects as well, with drones being used in warfare, an increase in deep fakes necessitating enhanced cybersecurity, and AI-generated materials being utilised for propaganda in political campaigns.

It is important to remember that AI reflects the humanity of its data. Learning good behaviour could benefit humanity, while hateful behaviour could be highly destructive. Amid these developments, truth and relationships remain critical. Discernment and the ability to ask pertinent questions will become essential skills. Your children might attend university or learn to be 'prompt engineers' via their personal AI tutors.

In wealth management, alongside investment management, asset allocation, and tax and estate planning, the greatest value a human wealth manager provides remains behavioural. Understanding and managing cognitive and emotional biases, as emphasised by Daniel Kahneman (who passed away last year), is crucial for wealth accumulation. Like AI, human biases are neither inherently good nor bad but are shortcuts that can yield positive or negative outcomes.

A TOUGH YEAR AHEAD FOR GLOBAL EQUITIES?

We have a responsibility in our role as custodians of our client's wealth, and are privy to their hopes and dreams as well as their anxiety and fears for themselves and their families. Emotions are powerful forces in investing. Making sure investments align with personal purpose and values can bring meaning to wealth and result in better outcomes.

Conversely, anxiety and fear can lead to detrimental decisions, such as disinvesting during market volatility, which could cause permanent capital loss. Our brains are hardwired for loss aversion bias, and despite knowing that patience and long-term investing through cycles generate better results, our primal instincts can take over. We accommodate this loss aversion bias in our asset allocation construction. We also meticulously assess risk tolerance, which is shaped by personal experiences and investment history. Risk tolerance is dynamic and can evolve with positive experiences or negative experiences. This is why the strength of relationships with our clients is so important, to support them and understand them in a deeper way to ensure sustained financial well-being.

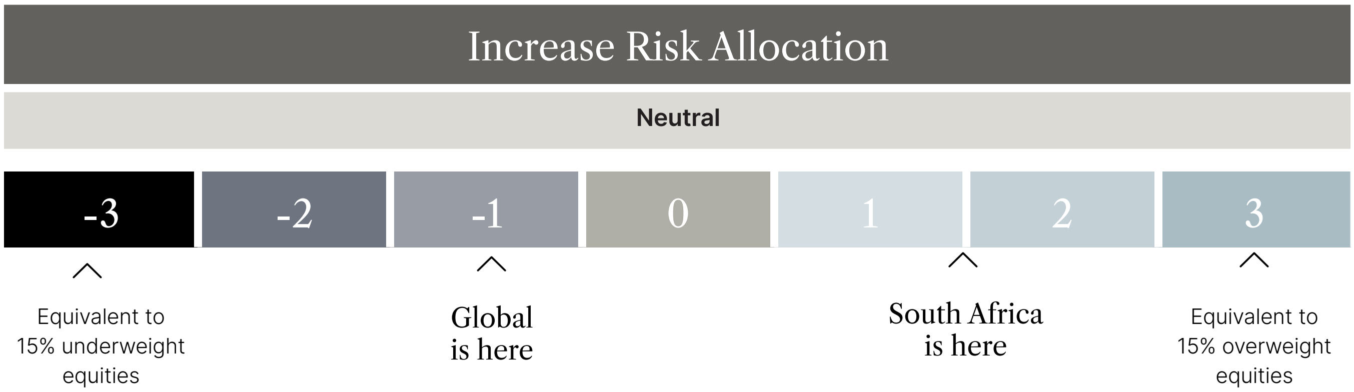
Looking forward, we will further develop our approach. After seven years of researching behavioural and emotional biases, neuroscience, and goals-based investing, we are ready to introduce our new wealth philosophy. We recognise that as humans, we invest for safety and aspiration.

Going forward, we will create components that meet these financial and emotional needs clearly and effectively. Our philosophy aims to help our clients move beyond merely outperforming benchmarks to achieving financial well-being and fulfilling personal purpose, aligned with their values and thus meeting their financial goals.

In line with our overall purpose of creating enduring worth, we aim, through our trusted relationships, to create a sense of safety, a life of prosperity, and a meaningful legacy for our clients, for generations to come. We look forward to engaging more on this in 2025. We wish you a healthy, connected and prosperous year ahead.

Marc Romberg and Ali Nortier
Joint Heads of Wealth Management

The GISG kept its global risk budget score at -1 on a scale of +3 to -3, while the SA risk score was maintained at 1.5 on a scale of -3 to +3



Summary

US GDP growth has been resilient and earnings growth has been strong. The current consensus forecast is for double digit earnings growth in the US over the year ahead and GDP growth of around 2%.

However, the Fed has signaled that it is likely to adopt a cautious approach over the year ahead, dimming the prospects of further sizeable rate cuts. US fiscal pressure is building and the outlook for US commercial real estate assets is cloudy, even if systemic risk is limited. Despite the risks, the US market offers little to no margin of safety, in our view. We see better opportunities outside of the US and have remained risk-off globally.

In contrast, we see evidence of a structural turnaround in South Africa with still cheap assets. Foreign interest in South African equities has been practically non-existent over the past year and we expect that as better economic data translates into stronger earnings growth there will be renewed interest in South African assets from abroad. In addition, inflation remains low and while it will likely start to increase, we expect it will be below 4% for the next six months. We remain overweight South African risk assets.

We expect that as better economic data translates into stronger earnings growth there will be renewed interest in South African assets from abroad.

Rationale:

The US economy is still strong. The current consensus forecast is for the US economy to grow by 2.1% this year and 2% next year. This is well above most developed market peers. Over the past four quarters, US GDP growth has been above the 70th percentile (i.e in the top 30%) across the globe. The US economic surprise index has turned positive and the Fed has cut rates, albeit signaling a slow pace of cuts to come. The Atlanta Fed GDPNow estimate for Q4 is well above 2%.

Fiscal pressures are building. The US government interest bill is near 3% of GDP, the highest in at least 60 years. At some point in the near future the interest bill will start crowding out other federal expenditure in the US.

A change in policy is coming in the US. The red sweep is likely to see a change in the US when it comes to regulation and climate change policy, even if the margin in the House is narrow.

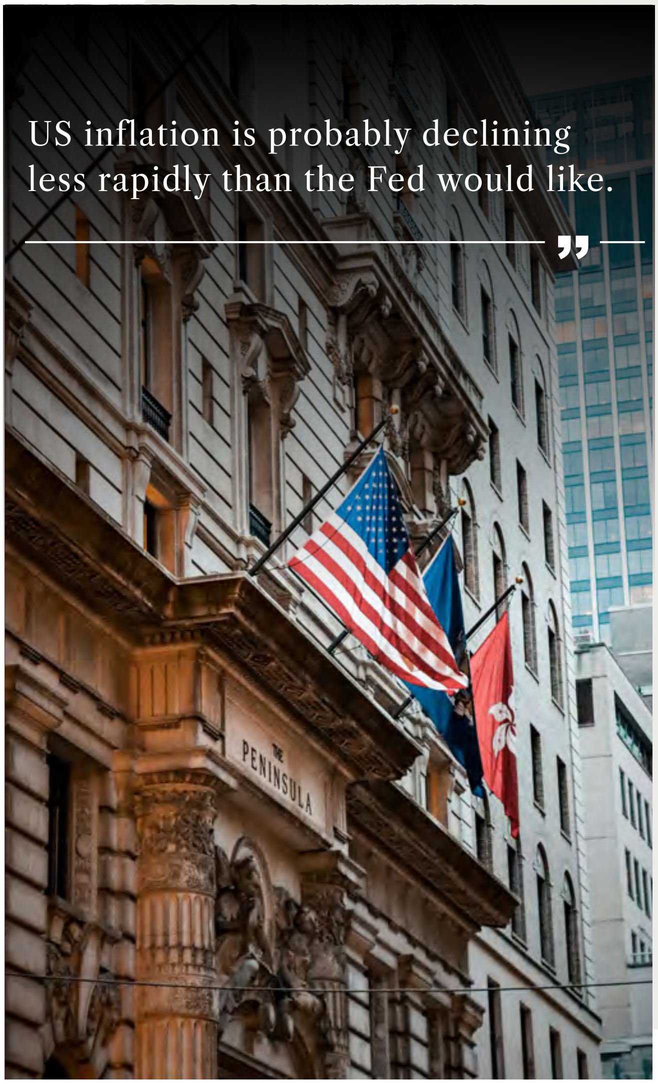
> The red sweep is likely to see a change in the US when it comes to regulation and climate change policy, even if the margin in the House is narrow.

Inflation is sticky. US inflation is probably declining less rapidly than the Fed would like. In addition, there is a material risk that tariffs push up inflation, even in the short term. The net result is that the Fed is likely to be slow to cut rates.

The ECB is cutting too. Inflation is close to the central bank target, and growth is weak. This means that the European Central Bank (ECB) is likely to continue to cut rates for the foreseeable future. The market is pricing in four cuts of 25bps each by year end.

The Bank of Japan is set to hike. Strong wage growth could well sway the Bank of Japan to hike as soon as January. The last time it increased rates there was a material increase in global volatility. The market is pricing in two hikes of 25bps each in Japan by year end.

The US labour market in question. Several leading indicators suggest that the US labour market is due a slowdown post strong prints in November and December. Historically, once the unemployment rate starts to increase it marks the beginning of the end of the economic cycle.



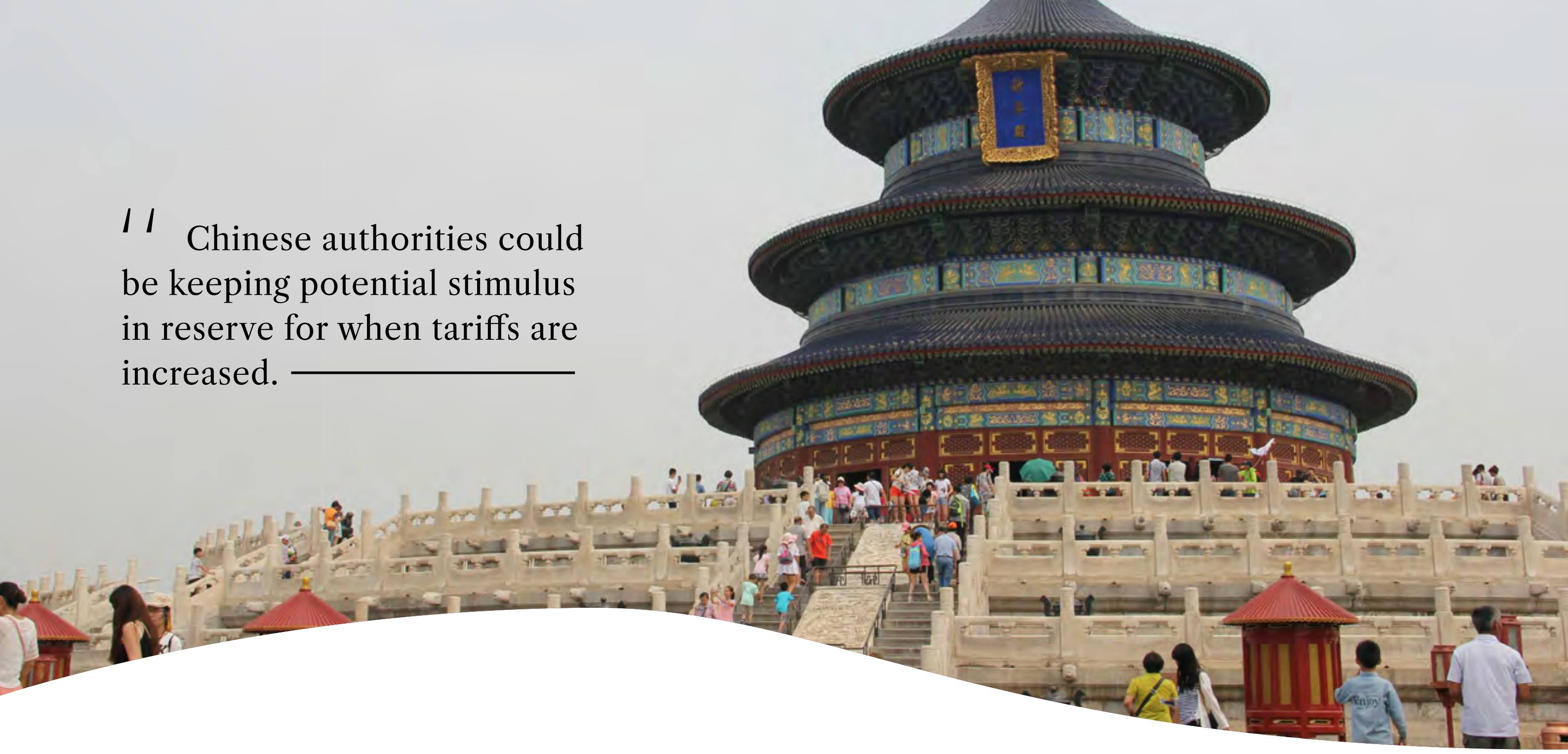
Risks remain to the US housing market. Rate cuts raise the prospect of lower mortgage rates – which should see a thawing of the US house market. Even as rates are cut the aggregate amount spent on interest on mortgages could well increase as people move and finance at higher rates than their prior bond. Lower rates should see more supply coming to the housing market – which could also depress prices.

Having said that, our base case remains that US house prices will remain flat over the year ahead.

Commercial real estate prices should continue to decline. We expect that commercial real estate prices in both the US and Europe will continue to decline – but not enough to pose systemic risk. Commercial real estate delinquency rates are still low but increasing.

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.

" Chinese authorities could be keeping potential stimulus in reserve for when tariffs are increased.



Risks to the Chinese outlook remain. The three-month average of total social finance, a key leading indicator for the Chinese economy, is down year-on-year, implying a soft nine months ahead. Rising exports may prove to be temporary as pre-tariff stockpiling is satiated. House prices continue to deflate – which will likely have knock on consequences for consumption given wealth effects. While inflation is well below the central bank target, there is risk in cutting rates due to low bank margins. Low bond yields offer the potential for fiscal stimulus but there has been little sign that it will be done at scale so far. The net result is that Chinese growth is likely to be underwhelming for the foreseeable future.

Having said that, high-yield and investment-grade corporate credit spreads are well below the levels seen in September 2022, around the time that an Evergrande default became apparent. Chinese authorities could be keeping potential stimulus in reserve for when tariffs are increased.

" There is a question mark over the extent to which recent investment in AI will generate returns for investors. "

Will AI spending prove justified? Capital expenditure on AI has ramped up – with little sign of a return on investment yet. It could well be that widespread adoption of AI ushers in a new era of productivity growth – but there is also the risk that it takes longer than the market expects to occur. In the interim there is a question mark over the extent to which recent investment in AI will generate returns for investors.

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 over the coming year. There is material risk of sizeable downgrades over the coming months even if margins remain higher than average.

The US equity/bond correlation is expected to decline. Research shows that periods of low inflation volatility are associated with lower equity/bond correlations. Inflation volatility has recently declined materially – suggesting a lower equity/bond correlation ahead.

US market expensive. While the EU and emerging markets screen as approximately fair value using our valuation technique, the US market still screens as around 40% over valued. European equities trade at a near record discount to the US using a variety of valuation techniques.

The rest of the world looks more attractive. Both earnings and dividend-based models show Europe, UK, and emerging markets are now 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.

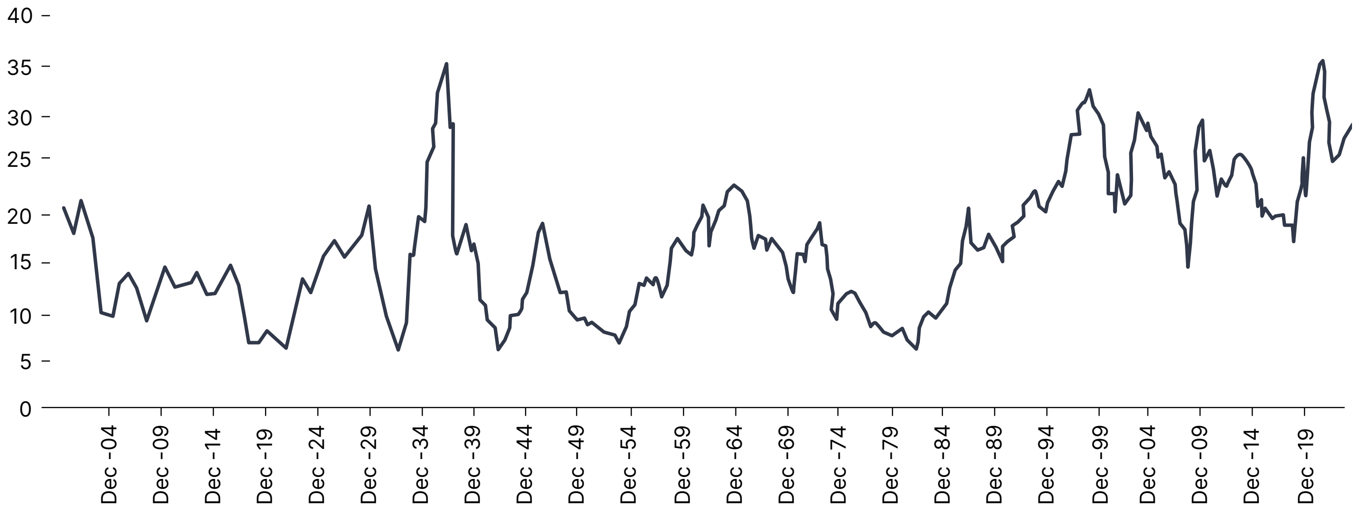
The US dollar is set to remain strong, for now. The US dollar screens as expensive but, given likely turmoil over the coming year, we expect that it will remain strong for now. However, we do expect the dollar to weaken over the medium term.

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

Valuation:

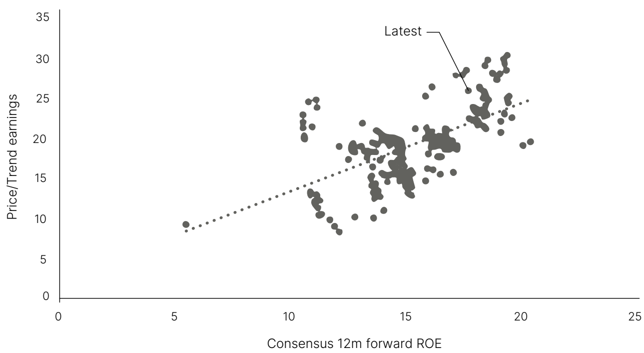
Our valuation model shows the US market to be trading well above fair value. We get similar results using price/earnings (P/E), price/book (P/B) and economic value/earnings before interest, depreciation, tax and amortisation (EV/EBIDTA) valuation metrics. In contrast we estimate European and emerging markets to be around fair value. **US price-to-trend earnings are high by historical standards, even after adjusting for return on equity.**

Price/Trend earnings



Date sampled: 4/11/2024
Source: Investec Wealth & Investment, Bloomberg

S&P 500 valuation (00-24)



In summary, the US market still offers little margin of safety while equities in the rest of world screen as fair value/ offering value. **More 'cons' than 'pros' to the market outlook. Tallying up the pros and cons to the market outlook gives a list that's weighted towards cons. There is therefore ample reason for a cautious approach and hence we have maintained our risk score at -1. We list the key pros and cons below:**

Date sampled: 13/11/2024
Source: Investec Wealth & Investment, Bloomberg

Pros:

- Rate cuts
- Market resilience
- GDP growth resilience
- Earnings growth strength

Cons:

- Valuation
- Back end of the cycle
- Potential risks from commercial real estate
- Fiscal pressure is building
- Signs of weakness in the labour market
- Optimistic earnings expectations

South African market view and asset allocation – keeping the local risk score to 1.5

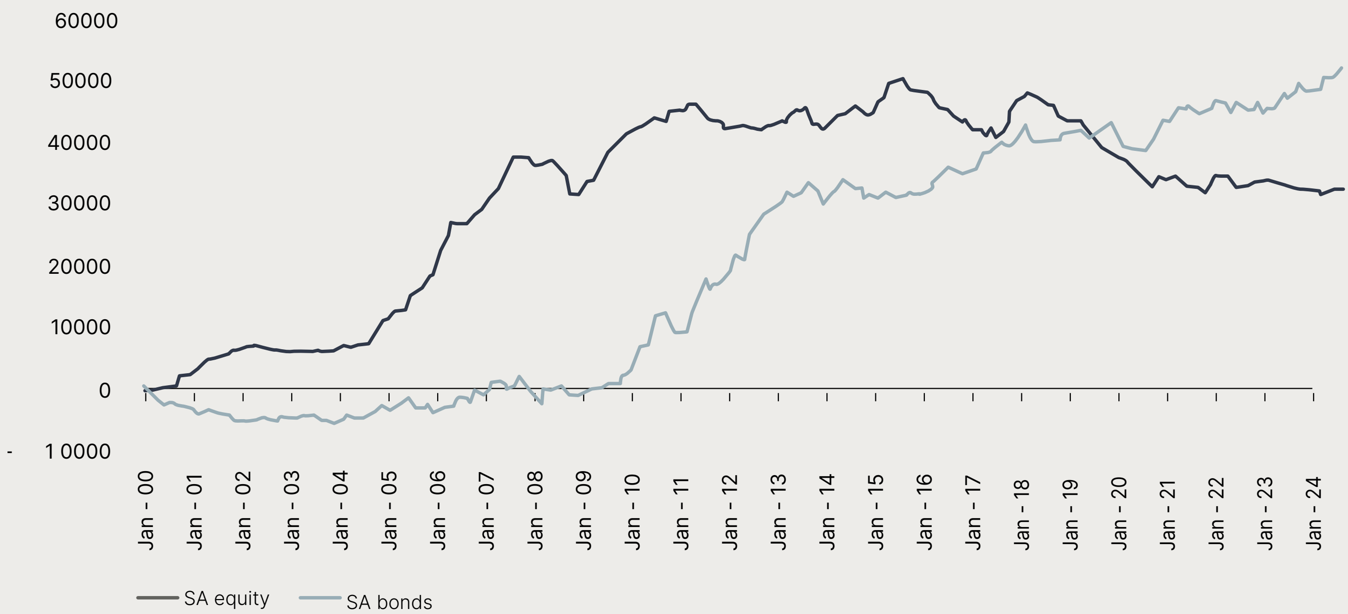
Performance has been strong. South African assets have rallied strongly since the election. The key question at the latest asset allocation committee meeting was whether we should retain our overweight South Africa call given the strong rally. The unanimous view was that we should remain overweight South African equities and bonds with a preference for equities over bonds.

Are we seeing a structural improvement? Much of the debate at the committee was around the extent to which a structural improvement in growth in South Africa was evident. There has been significant progress on the electricity front and there is clear focus from government on a set of other binding constraints on growth. However nominal GDP growth remains well below the government bond yield, suggesting that a recovery may prove to be cyclical. The committee agreed to monitor a range of variables to track improvements in South Africa's potential growth.

Foreigners have shown little interest in South African equities so far. Foreign flows into the bond market have been strong but foreign flows into equities have been near non-existent over the past year. Strong fourth quarter results from so-called 'SA Inc' counters could well spark some foreign interest.

> "There has been significant progress on the electricity front and there is clear focus from government on a set of other binding constraints on growth.

Cumulative flows ($m)



Date sampled: 02/12/2024
Source: Investec Wealth & Investment, IIF

Expectations are low. The IMF expects growth in South Africa to be in the bottom 15% of countries over the coming five years, an unprecedented scenario for South Africa. We expect that growth will materially beat expectations.

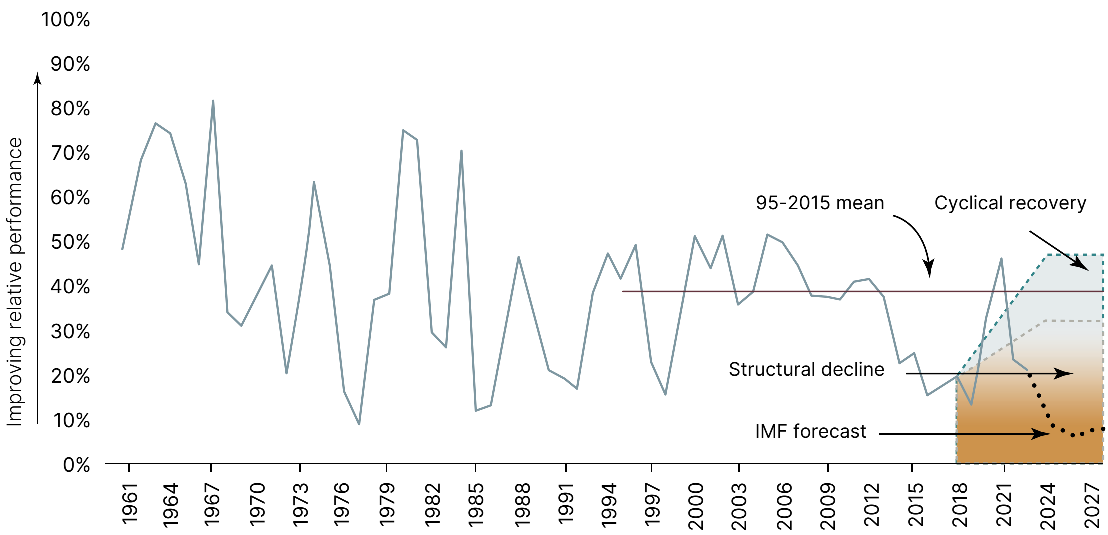
There is a chance of upgrades. If the debt-to-GDP trajectory from Treasury proves to be accurate, we expect to see upgrades from rating agencies over the coming 18 months.

Inflation is under control. South African inflation is below the bottom end of the range. While it is set to increase, we expect that it will still be below 4% in six months – allowing ample scope for rate cuts.

Fourth quarter growth is likely to be strong. Fourth quarter GDP growth will likely be strong – boosted by consumer spending. Early evidence suggests sizeable withdrawals linked to the new two-pot retirement system and consumption is likely to be further aided by lower rates and fuel price cuts.

A normal environment implies strong returns for South African assets. Given the structural improvements in the SA economy, we do not think it is unreasonable to expect the P/E of the local market to revert to the long-term average and for earnings to grow in line with the long-term average. In total, that would imply double-digit annualised returns for the All Share Index over the coming year.

SA GDP rank-percent relative to the rest of the world



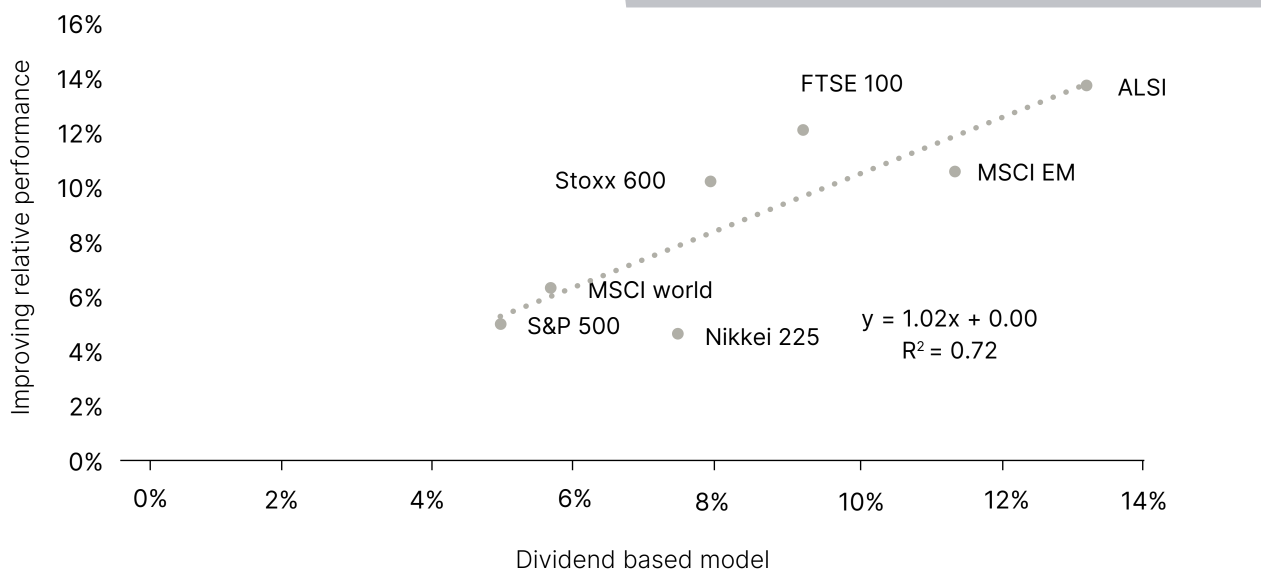
Date sampled: 02/12/2024

Source: Investec Wealth & Investment, World Bank

Risk spreads are set to narrow. Pre-2012 the average spread that the South African long-bond yield traded at relative to the US was around 500bps (five percentage points). It is currently over 600bps. A normal environment in South Africa implies good fixed income returns ahead. Even so, we have a preference for bonds in the so-called 'belly' of the curve, rather than at the long end, given the recent strong performance.

> " Early evidence suggests sizeable withdrawals linked to the new two-pot retirement system and consumption is likely to be further aided by lower rates and fuel price cuts.

Model expected local currency returns



Date sampled: 28/11/2024
Source: Investec Wealth & Investment

South Africa is cheap. Despite the nascent signs of a turnaround, South African assets still trade at a material discount to global peers. Equities, bonds and the rand all trade materially below our estimate of fair value.

Mid and small caps are attractive. Even after the recent rally, we expect South Africa's mid and small caps to do well over the coming year. Mid and small caps should be primary beneficiaries of a stronger South African growth environment and we expect will start to draw the attention of global investors.

'SA Inc' is our preferred sector. We expect that improving electricity availability and a continuing reduction in rates will see a rerating, with upside risk to earnings forecasts.

Reconciliation with GISG. The GISG score is -1 on the back of recent strong global equity performance, while the economic outlook has not appreciably changed and US equities are still expensive. The outlook for South Africa has materially improved and there is still a significant margin of safety in South African assets in our view, leading us to maintain our South African risk score at 1.5.

> Despite the nascent signs of a turnaround, South African assets still trade at a material discount to global peers.

> Mid and small caps should be primary beneficiaries of a stronger South African growth environment and we expect will start to draw the attention of global investors.

Valuation and asset allocation:

The SA risk score is maintained at 1.5

Valuation: Based on our estimates, South African asset classes screen as cheap both in an absolute sense and relative to peers. Global assets screen as expensive.

South African equities: Screen cheap with structural tailwinds. SA Inc is our favoured sector. Overweight.

South African bonds: Screen cheap, with the prospect of support from lower global bond yields, lower local inflation and rates.

Cash: We expect the SA Reserve Bank to continue to cut rates

Gold: Overweight as a geopolitical hedge.

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 CLASS	Q4 2024	Q1 2025	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. US nominal bonds in particular.
Global Cash	+	+	Overweight given global uncertainty.
Emerging Markets	N	N	EM equities screen as reasonably priced, in contrast to US equities. EM rate cuts should provide support.
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 2024	Q1 2025	COMMENTS
SA Equity	+	+	SA equity market cheap. Structural reform starting to bear fruit. SA Growth likely to exceed expectations over coming few years.
SA Fixed Income	+	+	Rate cuts to provides support for Fixed income. Improving structural outlook for SA should be a tailwind too.
SA Cash	--	--	Short rate to decline materially over coming year. We prefer to be exposed to SA risk and get insurance from offshore cash and fixed income.
SA Preference Shares	+	N	Valuation closer to fair value but potential upside if banking preference shares bought back.
USD/ZAR (+ for ZAR strength)	N	N	Recent Rand strength has brought the Rand close to 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 2024	Q1 2025	COMMENTS
Global Plays	-	-	Global outlook still in question, better value in SA Inc shares.
Commodities	N	N	Strong long term support from global energy transition, neutral for now given global outlook.
Precious Metals	-	-	Better opportunities in diversifieds and SA Inc.
SA Plays	++	++	SA consumer spend likely to pick up materially, aided by rate cuts and access to two-pot system.
Property	+	+	More opportunity in the SA focused counters than at the index level.
Small/Mid cap	++	++	Valuations still attractive. Improving growth outlook for SA not yet recognised in price of sector.

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

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 3201
Telephone: +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