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OUT OF THE ORDINARY

Global Investment View

April 2023

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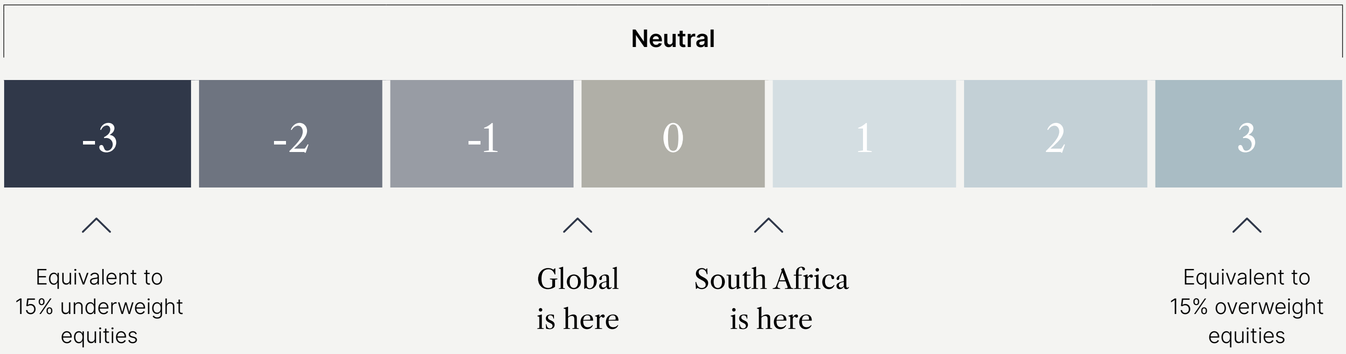
Favouring the rest of the world over the US

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 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.

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 also 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

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).

Summary

While the Fed has so far successfully contained the risk to the US banking system, it has in effect also bought itself space to keep rates elevated. We expect a recession in the US to start shortly but this does not yet seem to be reflected in consensus earnings forecasts. While inflation is coming down, partly due to reduced demand, we do not think it will come down quickly enough to prevent the Fed from pushing the US into recession. In addition, the US equity market offers no margin of safety in our view. Equities in the rest of the world look more attractive as does global and US fixed income outside of high-yield credit.

We continue to expect higher returns from equities and bonds in South Africa than from abroad. South Africa is not without risk though – declining performance at key state-owned enterprises (SOEs) is a binding constraint on growth and has kept the allocation to SA Inc shares at neutral, despite compelling valuations. The reopening of the Chinese economy, combined with continuing strong investment in the global energy transition and disciplined supply from miners should, in our view, continue to provide support for commodity prices and South African exports. We expect the rand to strengthen by 5% against the US dollar over the year ahead.

Rationale:

Central banks to support banks

One of the legacies of the Global Financial Crisis is that central banks are quick to provide support to failing large banks. So far, this latest period has not been any different. There may be some longer-term unintended consequences from the Silicon Valley Bank (SVB) collapse – such as a rush to larger banks and a more concentrated banking sector – but we expect little short to the medium-term risk of financial instability in either the US or Europe. Banks in general, however, maybe even more cautious – already lending standards surveys were pointing to a tightening of standards even ahead of the run on SVB – which will not be supportive of faster GDP growth over the short to medium term.

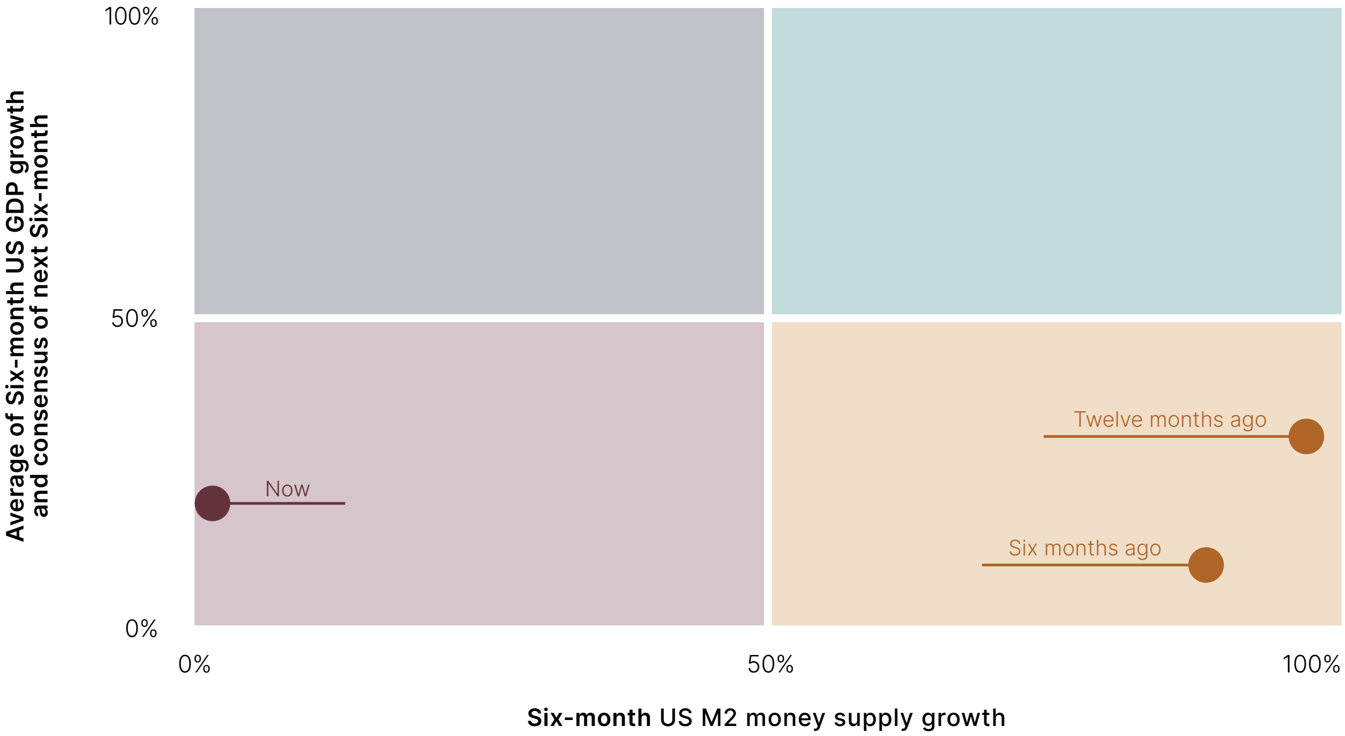
US to go into recession

The leading indicator, the yield curve, consumer expectations relative to the current position and defaults all point to a recession starting soon in the US, if it has not already started. While still significant excess savings imply the recession will be of the milder variety, there will nonetheless likely be a decline in real economic activity in the US. At the same time, lower inflation and low growth imply much lower top-line growth for US corporations – and the possibility of negative operating leverage. Given this scenario, the consensus forecast of mid-single-digit earnings growth for the S&P 500 this year and next, seems too optimistic.

Growth weak, low levels of liquidity

Six-month US M2 money supply growth is running at -1.7%, the lowest reading in at least 40 years. US growth is weak too. The 12-month period from Q3 last year to Q3 next year is likely to see US GDP growth of just 1.5%, implying 12-month growth in the bottom 22% of observations since 1980. The combination of weak GDP and money supply growth supports a continuing risk-off position.

Percent rank since 1980



Date sampled: 17/03/2023
Source: Investec Wealth & Investment, Bloomberg

Europe is likely to go into recession

Surprisingly warm weather in Europe has meaningfully contributed to reduced demand for gas – and a precipitous fall in gas prices despite the ongoing Russian invasion of Ukraine. The fall in gas prices may have been sufficiently large to allow for energy prices to no longer be a binding constraint on growth in Europe. However, core inflation continues to increase and is uncomfortably high at 5.6%. The net result has been a recent half percentage point rate increase by the European Central Bank (ECB) and we expect that the ECB will continue to hike over the short term – providing a strong headwind for growth in Europe.

China is rebounding

Chinese inflation, at 1%, is well below the central bank target of 3% and allows for the possibility of further stimulus should the Chinese economy slow. In the meantime, money supply growth in China is running at close to 13% (vs -1% for the US) and the three-month average of total social finance is up year-on-year, implying stronger growth over the coming nine months. Chinese manufacturing activity has already started to rebound and we expect it will be strong over the year ahead. Still tight commodity inventories in China imply support for commodity prices over the year ahead, despite the slowdown in developed market economic activity.

Growth for the past two years and consensus for the next two

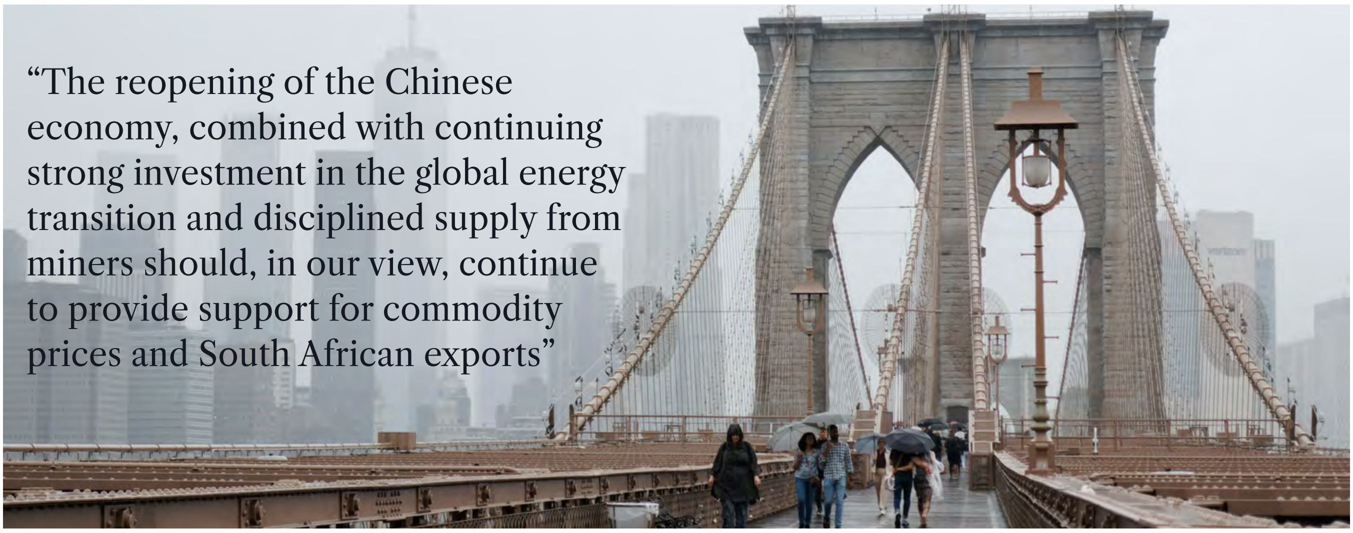
CONSENSUS GDP FORECASTS	21	22	23	24
USA	5.7	2.1	0.8	1.2
Japan	1.7	1.1	1.05	1.1
EU	5.2	3.45	0.5	1.2
Germany	2.8	1.9	0	1.2
France	7	2.6	0.5	1
Italy	6.3	3.9	0.5	0.9
Spain	4.8	4.6	1.2	1.45
UK	7.2	4	-0.6	0.9
China	8.1	3	5.3	5
South Africa	4.8	2.3	1	1.6
DM	5.21	2.73	0.73	1.35
EM	6.51	3.06	4.19	4.39
World	5.8	3.1	2.4	2.9

Date sampled: 17/03/2023 **Source:** Bloomberg, Investec Wealth & Investment

Inflation declining and likely to continue to surprise on the downside

US money supply growth is negative for the first time in over 50 years. Money supply growth is slowing materially in Japan and Europe too. In addition, global container shipping costs are down 85% year-on-year and wheat and oil prices are materially below their recent peaks. All of these factors point to a material slowdown in inflation over the year ahead.

In addition, the reopening of the Chinese economy, while likely to provide support for commodity prices, will further reduce supply chain constraints. A recession in the US, and possibly Europe, will further ease any remaining inability of supply chains to meet current demand. The consensus forecast is for US inflation to average 4.1% this year and 2.5% next year. We think these forecasts are too high.



> “The reopening of the Chinese economy, combined with continuing strong investment in the global energy transition and disciplined supply from miners should, in our view, continue to provide support for commodity prices and South African exports”

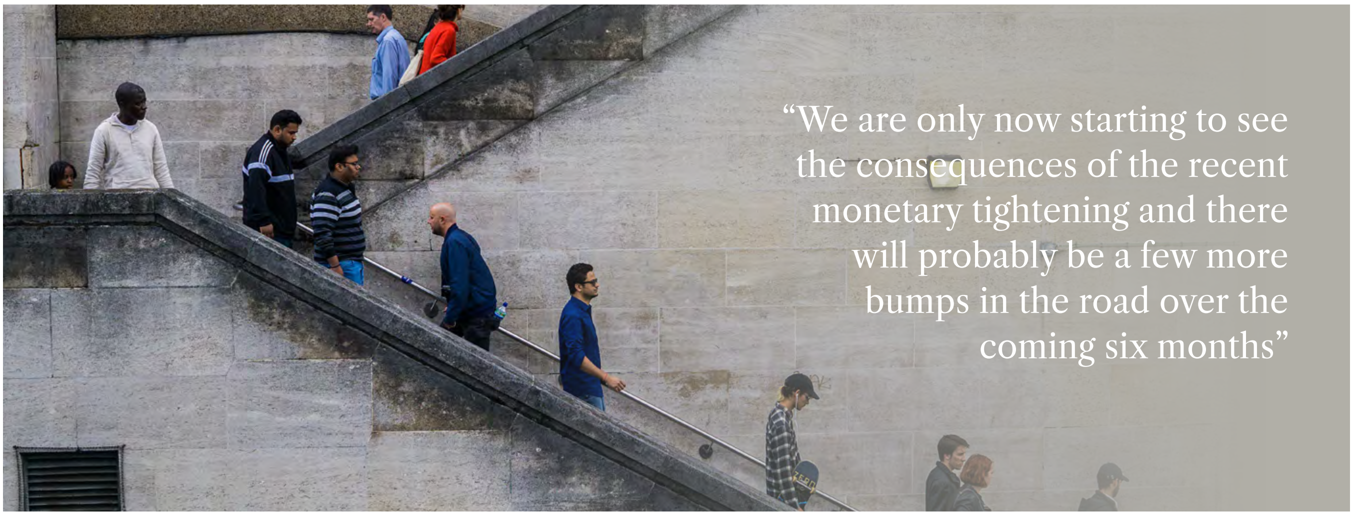
There are signs that the US labour market is about to soften

Quits have been in decline, with the National Federation of Independent Business (NFIB) hiring survey trending down, while US manufacturing has been weak. All of these point to a forthcoming slowdown in the US labour market. Having said that, the US labour market has been consistently stronger than market expectations over the past year and the Fed is likely to wait for clear signs of a slowdown before taking its foot off the brake.

The 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 are only now starting to see the consequences of the recent monetary tightening and there will probably be a few more bumps in the road over the coming six months.



> "We are only now starting to see the consequences of the recent monetary tightening and there will probably be a few more bumps in the road over the coming six months"

Higher rates will have fiscal effects

The surge in developed market yield curves over the past two years will start to affect the fiscal position of their 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 fiscal and monetary tightening happen simultaneously.

The US dollar is set to weaken

The trade-weighted, inflation-adjusted US dollar is still close to the strongest it has been in over 40 years. As global inflation continues to recede, we expect the US dollar to weaken. A weaker dollar should prove helpful for emerging markets and commodity exposure.

The US market is expensive

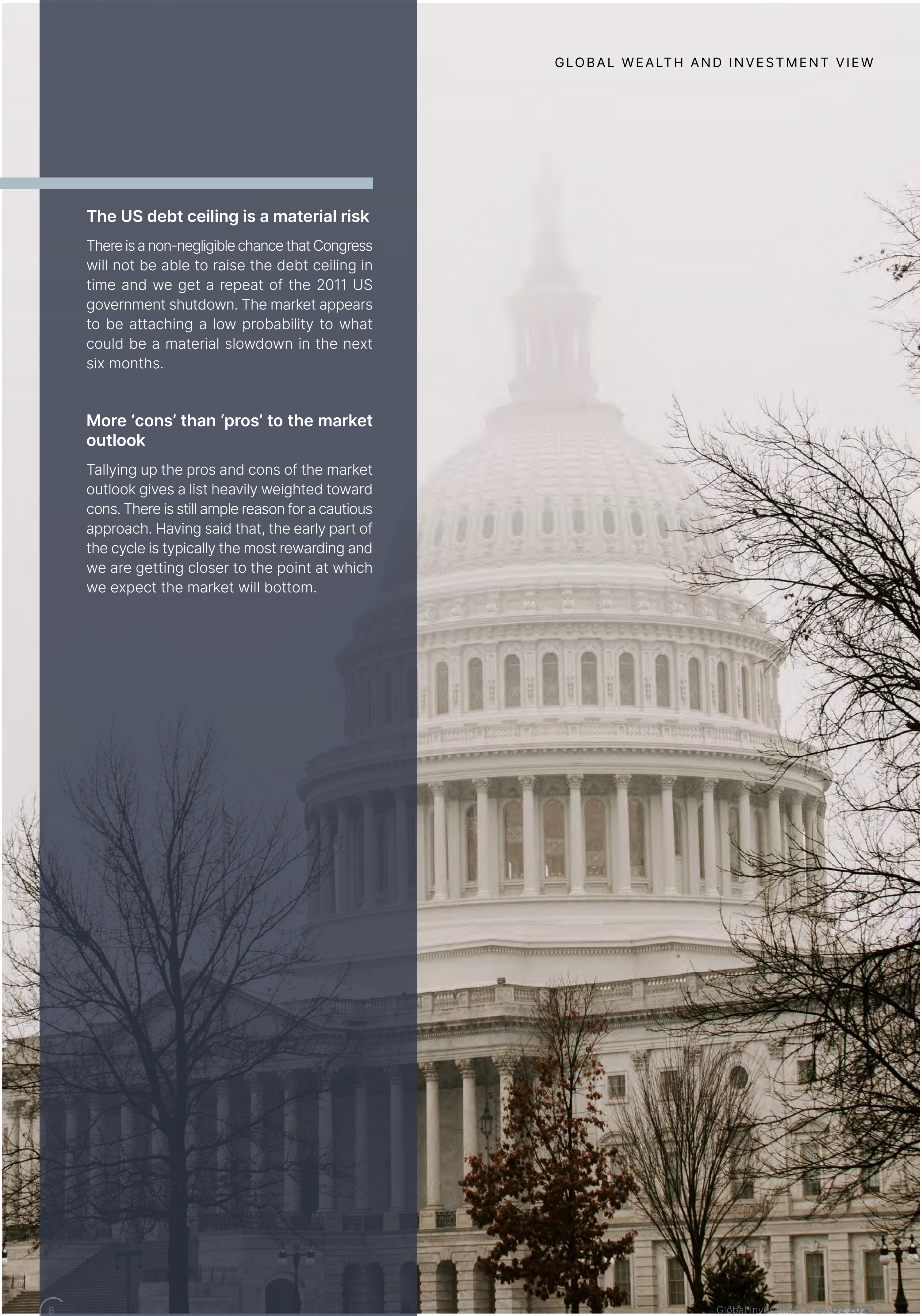
Our dividend-based model shows the US market to be about 20% overvalued. The HOLT-based implied discount for the US market is still low too. The forward price/earnings multiple of the US market is just under 18 times, a 5% premium to the 15-year median and we expect earnings to be downgraded.

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, however

Both earnings and dividend-based models show Europe, the 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's reopening and the still low inflation outlook in China means that its authorities have further scope for policy stimulus. A weaker US dollar should support the performance of the rest of the world over the US.

> "Both earnings and dividend-based models show Europe, the UK, and emerging markets to now be at or below fair value"



The US debt ceiling is a material risk

There is a non-negligible chance that Congress will not be able to raise the debt ceiling in time and we get a repeat of the 2011 US government shutdown. The market appears to be attaching a low probability to what could be a material slowdown in the next six months.

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

Tallying up the pros and cons of the market outlook gives a list heavily weighted toward 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 & asset allocation

Little reason for excitement

There's little reason to be excited about the South African economy over the year ahead

The South African economy has materially exceeded expectations over the past two years. Despite a markedly reduced growth forecast of just 1% over the year ahead, it is unlikely that growth will materially surprise on the upside again. Load shedding and failures at Transnet are taking their toll and the economy is likely to drift sideways over the year ahead. While the private sector is ramping up investment in distributed energy production – and shifting away from Eskom – we still expect load shedding to continue for at least two more winters.

The repo rate is likely to be cut by year-end

Inflation is likely to remain around 7% for the next two months, but thereafter fall rapidly. Within nine months, we expect inflation to be near the middle of the Monetary Policy Committee's target band (3% to 6%). The committee's own forecasts are not materially different. Should that be the case, it is difficult to see the repo rate not coming down (we expect at least 50bps of cuts by year end).

> "Load shedding and failures at Transnet are taking their toll and the economy is likely to drift sideways over the year ahead"

South African market view:

HENG DALI WATCHES
OPTICAL

South African equities are cheap

While earnings growth is likely to be tepid at best, the equity market is still remarkably cheap, with a forward price-earnings ratio of around 8. We expect South African equity returns to be well above those of the US over the year ahead.

South African government bonds are our preferred asset class

Government bond debt currently offers a significant margin of safety in our view. The slope of the yield curve in South Africa is still abnormally steep relative to peers and as the short rate comes down, we expect this will bring down the long bond yield too. The upcoming election next year raises the prospect that the government will temporarily be less fiscally prudent but with double-digit yields, we still see an upside in government debt.

"The slope of the yield curve in South Africa is still abnormally steep relative to peers and as the short rate comes down, we expect this will bring down the long bond yield too"

Commodities set to do well

It is not often the case that commodities do well as developed markets go into recession but we think this time may be an exception. China is stimulating, we expect the 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.

"China is stimulating, we expect the dollar to weaken and the global energy transition should provide a meaningful tailwind for commodity prices"

The rand is set to strengthen

We expect the rand to strengthen against the US dollar by around 5% over the year ahead, largely due to dollar weakness. The rand is significantly weaker than our estimate of fair value, at around R15.50 to the dollar.

"The rand is significantly weaker than our estimate of fair value, at around R15.50 to the dollar"

AFRICA
LIBYA
EGYPT
ALGERIA
CHAD
SUDAN
NIGERIA

Asset allocation

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

Equities: Screen cheap but weak global returns are likely to be a strong headwind. Offshore resources are the favoured sector.

Bonds: Screen cheap, with support from continuing strong government revenue and the prospect of lower global bond yields. Local politics are likely to affect this asset class in particular though.

Cash: We expect the SA Reserve Bank to start cutting rates by year-end.

Property: Sufficiently cheap to justify a neutral position.

Gold: Still overweight but 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	Q1 2023	Q2 2023	COMMENTS
Global Equity	-	-	GISG score negative. Global growth set to weaken materially with sizeable downside risk to earnings forecasts. US market does not offer sufficient margin of safety.
Global Fixed Income	+	+	Global fixed income now screens as attractive. US nominal bonds in particular.
Global Cash	+	+	Still overweight given global uncertainty.
Emerging Markets	N	N	Emerging market equities screen as cheap value, in contrast to developed market equities. China reopening should provide a tailwind.
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	Q1 2023	Q2 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 SOE finance 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	-	N	Large discount to NAV. Hedged against increase in interest rates. Utility costs passed on to tenants.
SA Preference Shares	N	N	Very strong performance has moved valuations close to fair value.
USD/ZAR (+ for ZAR strength)	+	+	USD/ZAR weaker than our estimate of fair value. We expect $ to weaken over coming 12m.
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	Q1 2023	Q2 2023	COMMENTS
Global Plays	N	N	Neutral. Global outlook weak but global plays offer a hedge vs SA specific risk.
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	N	N	Cheap but SOE related issues likely to see cost pressures and weak volume growth.
Small/Mid cap	+	+	Valuations still attractive.

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

Global Investment Strategy Group

Chris Hills

Chief Investment Consul United Kingdom

Professor Brian Kantor

Chief Economist & Strategist Investec Wealth & Investment South Africa

Philip Shaw

Chief Economist Investec PLC

John Wyn-Evans

Head of Strategy United Kingdom

Andrew Shard

Divisional Director / International Investments United Kingdom

Nik Kidd

Senior Investment Director United Kingdom

Ryan Friedman

Portfolio Manager & Head of Multimanager South Africa

Paul Mckeaveney

Portfolio Manager & Chairman SA Asset Allocation Committee South Africa

Neil Urmson

Wealth Manager South Africa

Annelise Peers

CIO Switzerland

Chris Holdsworth

Chief Investment Strategist South Africa

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