Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q3 2023

Contents

Central banks stay hawkish

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's professionals in the UK, South Africa and Switzerland.

The Group meets quarterly to map out our outlook over the following eighteen months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.

Chris Holdsworth, CFA

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Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Investec Wealth & Investment South Africa. His research covers asset allocation and sector selection, both locally and internationally. Chris comes from the research team in Investec's equity business, where he was an investment analyst for 12 years, 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).

The 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

Summary

Global equities have recently rallied on the back of resilient earnings, inflation surprising on the downside and some degree of enthusiasm for the artificial intelligence (AI) theme. However, the global economy continues to slow and we are yet to see the full effect of recent rate increases. The Fed and European Central Bank (ECB) remain hawkish and seem willing to err on the side of causing a material slowdown in growth. The US equity market is around 20% above our estimate of fair value – with headwinds from slowing top-line growth ahead. As a result, we have kept the GISG score at -0.5. Risks for the market are likely short-term loaded and we are not too far from peak rates and even rate cuts – providing reason for not being more underweight. Europe screens as cheap and emerging markets are close to fair value according to our model.

South African equities and fixed income screen as cheap. We expect continuing improved performance from Eskom to translate into lower operating costs for 'SA Inc' over the year ahead with earnings likely to be further supported from the knock-on effects of lower rates. 'SA Inc' is our preferred sector in the South African equity market. South African fixed income offers a significant margin of safety and is our preferred asset class domestically. We expect the rand to strengthen over the coming year.

"The Fed and European Central Bank (ECB) remain hawkish and seem willing to err on the side of causing a material slowdown in growth"

Rationale:

Equity returns have recently been strong

While there are clear signs that the US economy is inching towards a recession, earnings have been resilient, inflation has surprised on the downside and recent improvements in AI functionality have caught the attention of investors.

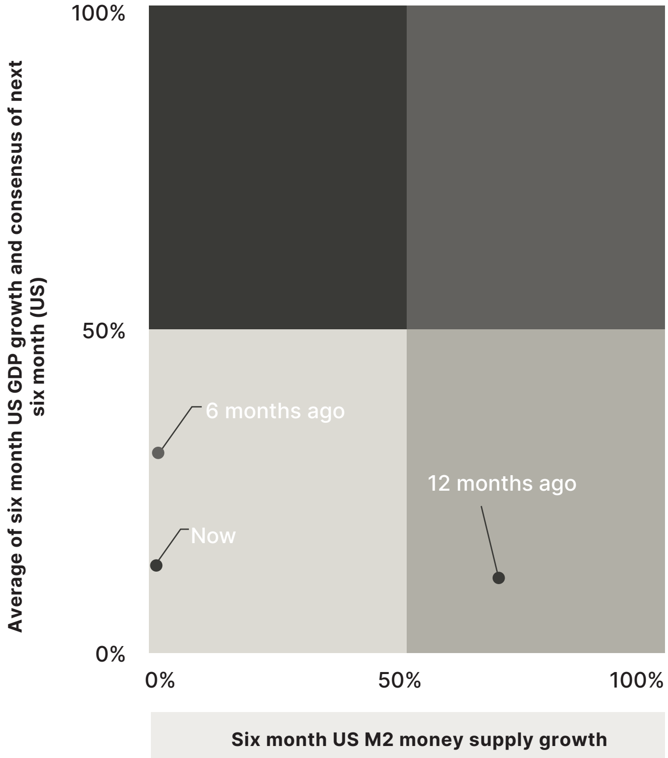
Inflation to continue to decline – in line with market expectations

Inflation has regularly surprised on the downside over the past six months – both in the US and across the globe. While we expect inflation to continue to decline, we now no longer expect it to surprise on the downside. The market is pricing US inflation to drop to 1.8% in twelve months from now.

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. 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 optimistic. The global manufacturing PMI is already well below 50. The services PMI is well above 50 but we expect this will roll over as excess savings are reduced.

Percent rank since 1980



Date sampled: 23/06/2023
Source: Investec Wealth & Investment, Bloomberg

> While there are clear signs that the US economy is inching towards a recession, earnings have been resilient.

Europe is to see weak growth too

While food and energy prices have peaked, we expect the ECB to continue to err on the side of caution – putting pressure on consumers. Europe is already in recession and we do not expect to see growth pick up materially over the year ahead. The consensus forecast is for GDP growth of around 1% a year across developed markets for this year and next.

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

	21	22	23	24
USA	5.7	2.1	1.1	0.73
Japan	1.7	1.1	1.1	1.1
EU	5.2	3.45	0.6	1
Germany	2.8	1.9	-0.15	1.05
France	7	2.6	0.6	1
Italy	6.3	3.9	1	0.8
Spain	4.8	4.6	1.85	1.4
UK	7.2	4	0.2	0.9
China	8.1	3	5.54	4.9
South Africa	4.8	2.3	0.3	1.41
DM	5.21	2.73	0.99	1.1
EM	6.51	3.06	4.26	4.25
World	5.8	3.1	2.6	2.7

Date sampled: 14/06/2023
Source: Bloomberg, Investec Wealth & Investment

The Chinese rebound has been underwhelming but more stimulus is on the way

While Chinese economic activity has been picking up, it has been below expectations. In response, the People's Bank of China (PBoC) has recently cut rates and we expect a broad stimulus package to be announced within the next few weeks. There is some urgency – youth unemployment has been ratcheting up and is now above 20%. Fortunately, there is space for significant monetary support. Unlike most of the rest of the globe, Chinese inflation is low (at 0.2% currently vs a central bank target of 3%). However, it will be difficult to fully compensate for weak exports – the knock-on consequence of weak developed market growth. Chinese exports are already down 7% year-on-year, further reason to see stimulus shortly.

Signs that the US labour market is about to soften

Quits have been in decline, the National Federation of Independent Business (NFIB) hiring survey has been trending down and US manufacturing has been weak – all of these point to a forthcoming slowdown in the US labour market. In addition, initial jobless claims are now running at 40,000 above the recent non-Covid normal. It seems the US labour market is finally starting to weaken – consistent with an imminent start to a recession.

Will the Fed continue to hike?

While US headline inflation is declining rapidly and will probably be close to 3% shortly, core inflation is proving to be sticky. The net result is persistently hawkish messaging from the Fed (and a similar situation in Europe). The Fed has guided that it intends to still hike even as the outlook for headline inflation has improved and the growth outlook has deteriorated. The risk of policy error is very high at this point if it hasn't already occurred. There is also the risk that developed market central banks will be too slow to cut once consumption slows materially.

The consequences of rate hikes have yet to be established

The current rate hiking cycle has been the steepest in at least forty 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. Banks have been tightening lending standards too – suggesting a material slowdown in credit extension over the coming year.

> "The Fed has guided that it intends to still hike even as the outlook for headline inflation has improved and the outlook for growth has deteriorated"

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 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 fiscal and monetary tightening happen simultaneously.

The US dollar to weaken

The trade-weighted, inflation-adjusted US dollar is still not far from the strongest it has been in forty years. As global inflation continues to recede, we expect the dollar to weaken. A weaker dollar should prove helpful for emerging market and commodity exposure.

The US market is expensive

Our dividend-based model shows the US market to be about 20% overvalued. The forward price/earnings ratio of the US market is just over 20, a 16% 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

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's reopening and given still low inflation in China, Chinese authorities have further scope for policy stimulus. A weaker US dollar should support rest-of-the-world performance over the US.

US bond yields are set to decline over the coming 18 months

US Treasuries screen as cheap in our view. Inflation is heading lower and we expect US Treasuries to provide effective insurance should the probability of recession in the US escalate further. Implicitly, we expect a much lower correlation between equities and bonds over the coming twelve months as the focus shifts from inflation to growth. US Treasuries are our preferred insurance asset at this point.

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

South African market view and asset allocation – 'SA Inc' is our preferred sector

A rate cut by the MPC isn't far away

We expect that inflation will be in the middle of the target band by the end of the year. As in the US, if the Monetary Policy Committee (MPC) does not cut rates within six months, South Africa will have the tightest monetary policy in over a decade. We do not think the MPC will need to wait for the Fed to cut first – the MPC started to hike before the Fed did this cycle. The key risk to this view is the oil price. Should oil rally – unlikely in a global slowdown – then inflation could prove to be stickier than we expect.

The economy is currently weak but there's light at the end of the tunnel

South African economic data is currently weak. Vehicle sales, retail sales, credit extension, and nominal GDP growth are all unimpressive. In addition, employee tax receipts suggest that formal sector income growth is running below 5%. However, we expect to see a turn in 12 months. Inflation is receding quickly, which will allow the MPC to cut rates. In addition, Eskom's performance has improved, and should it continue to operate at these levels through summer, we would expect to see significant diesel savings by 'SA Inc' companies, which will drop straight to the bottom line.

South African 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 is still abnormally steep relative to peers and as the short rate comes down, we expect it will bring down the long bond yield too. The upcoming election next year raises the prospect that the South African government will temporarily be less fiscally prudent, but with double-digit yields, we still see upside in government debt. In addition, the yield offers significant insurance against our base case not panning out. Even if government bond yields go up by 100bps, which is not our expectation, by our calculation government bonds will give 5% over the year.

> "Should oil rally – unlikely in a global slowdown – then inflation could prove to be stickier than we expect."

South African equities are cheap

The equity market is unequivocally cheap. The trailing 12 month price/earnings ratio is trading at a 40% discount to the 10 year median. There is upside risk to earnings forecasts too, given the improving electricity situation.

> "Eskom's performance has improved and should it continue to operate at these levels through summer, we would expect to see significant diesel savings by 'SA Inc' companies, which will drop straight to the bottom line."

'SA Inc' is our preferred sector

SA Inc shares (shares whose performances are closely correlated with the performance of the domestic 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 upside risk to earnings forecasts.

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 headwind. SA inc likely to benefit from lower rates and lower diesel costs over coming 12m in our view. Resource counter have strong long term tailwinds but next six months likely to be difficult as global growth slows.

Bonds: Large margin of safety with falling inflation likely to provide support. Favored asset class, overweight.

Cash: We expect the MPC of the SA Reserve Bank to be cutting rates by year end.

Property: Sufficiently cheap to justify neutral position.

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

> "We expect that improving electricity availability and a potential reduction in rates will see a rerating [for SA Inc] with upside risk to earnings forecasts"

Asset allocation positioning:

The metrics below show our asset allocation positioning for global, domestic and by theme.

--	Underweight
-	Moderately Underweight
N	Neutral
+	Moderately Overweight
++	Overweight

GLOBAL ASSET ALLOCATION	Q2 2023	Q3 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 sufflicent margin of safety.
Global Fixed Income	+	+	Global FI 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	-	-	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	Q2 2023	Q3 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	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 US dollar to weaken over coming 12 months.
Physical Gold	+	+	Allocation to physical gold offers protection against SA and global risks, particularly the risk of higher than expected inflation. Rising real yields a concern though. Looking to reduce to neutral.

SECTORAL/THEMATIC POSITIONING	Q2 2023	Q3 2023	COMMENTS
Global Plays	N	N	Neutral. Global outlook weak but global plays offer a hedge vs SA specific risk.
Commodities	+	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	N	+	Expected decline in diesel costs over the coming year. Expected rate cuts helpful too.
Small/Mid cap	+	+	Valuations still attractive.

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

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