Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q4 2022

Contents

Central bankers to keep hiking, even as recession looms

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.

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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 a member of the Global Investment Strategy Group (GISG).

Strategy

GLOBAL WEALTH AND INVESTMENT VIEW

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 been reduced to +0.5 from +1

By Chris Holdsworth, Chief Investment Strategist, Investec Wealth & Investment and member of the Global Investment Strategy Group

Increase Risk Allocation

Neutral

-3	-2	-1	0	1	2	3
Equivalent to 15% underweight equities		Global risk score (-0.5)		South Africa risk score (+0.5)		Equivalent to 15% overweight equities

Summary

There are a multitude of signs that developed market growth is slowing and will likely slow further. We now have a recession in both the US and Europe penciled in as our base case. While we expect inflation to surprise on the downside over the coming 12 months, it will likely still be sufficiently elevated to see the Federal Reserve (Fed) and European Central Bank (ECB) continue to hike until the first quarter of next year. In addition, we expect the Fed to reduce the size of its balance sheet as guided – at a rate of $95bn/month. The combination of weak growth, low liquidity and increasing short rates is unlikely to be helpful for global markets and we remain risk-off outside of SA. US consumer balance sheets are still strong though and global employment continues to increase. While the US housing market is rolling over, mortgages were largely granted to consumers with strong credit scores during this cycle and banks are far less leveraged than prior to the Global Financial Crisis (GFC). There are enough 'pros' to keep our global score at -0.5, rather than reduce it to -1 or lower. While US equities still offer no margin of safety in our view, there are pockets of value elsewhere and US fixed income now screens as cheap.

We expect that US equities will underperform US fixed income over the coming three months.

While local bonds and equities screen as cheap, we expect the deteriorating global growth outlook to be a strong headwind for local equity performance. By our estimate, there is a large margin of safety in local government fixed income and continuing strong revenue growth, along with declining global long bond yields, should see local bond yields come in over the year ahead. We remain underweight SA property – we prefer to get yield exposure from local fixed income. Our SA risk score is +0.5.

"The combination of weak growth, low liquidity and increasing short rates is unlikely to be helpful for global markets and we remain risk-off outside of SA"

Our rationale

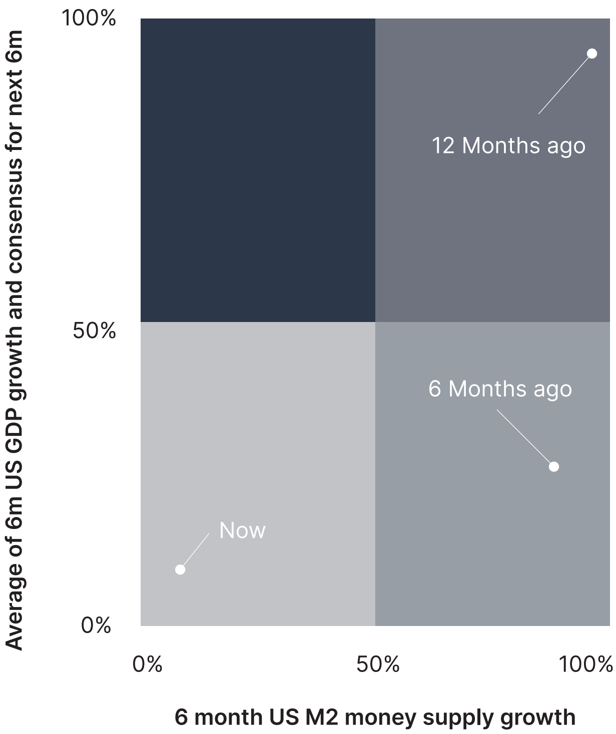
Growth is weak, liquidity is drying up

We are penciling in a recession in both the US and Europe within the next 18 months as our base case. The US has just seen two consecutive quarters of negative GDP growth and the consensus forecast is for the economy to grow at below 1.5% annualised in each of the next two quarters.

Both Europe and the US are expected to grow by less than 1% next year. At the same time, dollar liquidity is drying up. US M2 money supply is up by less than 0.3% over the past six months. The combination of weak growth and low levels of liquidity implies retaining a risk-off position.

"We are penciling in a recession in both the US and Europe within the next 18 months as our base case"

Percent rank since 1980



Date sampled: 15/09/2022
Source: Investec Wealth & Investment, Bloomberg

Inflation to surprise on the downside but Fed still to hike

US inflation peaked several months ago and while the decline so far has been slower than the market, and the Fed, would have liked, we expect that inflation will surprise on the downside over the coming 12 months as base effects come into play. Despite clear signs of inflation having peaked as well as numerous other indicators suggesting restrained demand, we expect that the Fed will still be aggressive over the next six months - and will be viewed as having made a policy error in 12 months' time.

"Despite clear signs of inflation having peaked as well as numerous other indicators suggesting restrained demand, we expect that the Fed will still be aggressive over the next six months"

Fed to still accelerate its balance sheet reduction

Even ahead of the acceleration in September, US Treasury market liquidity was at its worst level in five years. As liquidity declines further, we expect still higher bond market volatility – and therefore higher economic volatility over the coming year.

Higher rates will have fiscal effects

The surge in developed market (DM) yield curves over the past year will start to affect the fiscal position of DM governments. Once inflation recedes, the Fed and other DM central banks will need to follow shortly or we will see both fiscal and monetary tightening happen simultaneously.

Consensus earnings expectations still too high

There is still a large disconnect between consensus earnings forecasts and consensus forecasts of GDP growth in both the US and Europe. Part of this can be explained by nominal GDP growth remaining elevated due to high inflation – and therefore supporting earnings growth - but we still expect material downward revisions to earnings forecasts to occur over the coming six months.

Current cycle only has up to 12 months left

Central bank tightening has brought forward the point at which the current cycle ends and there is a material chance of a US recession in the near term. However, even should one occur, we do not expect it to be severe. The global economy is less sensitive to oil prices than before and US consumers still have access to sizeable excess savings should the labour market slow.

US housing market slowing

Median home sale prices in the US are down 6% off the peak and while still up year-on-year, there are some dark clouds building for the US housing market. Mortgage rates are over 6% for the first time since 2008 and mortgage applications are at Covid lows. While new home purchases are increasingly unaffordable, there is a record number of homes currently under construction – over 1.7 million homes are currently being built in the US. While the outlook for the US housing market is dim, we do not expect a repeat of the GFC. Mortgage lending has been far more prudent this time around and banks are better capitalised too.

US bond yields to decline over coming 18 months

For the first time in some time, US Treasuries now 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. Inflation linkers and credit screen as attractive too in our view.

US equity market not cheap yet

Even after the recent pullback we do not see the US market as cheap. 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. The forward P/E of the US market on the other hand is near 17, not far off the 15-year median, implying a market that is around fair value. The difference between dividend based valuation models and earnings-based models can be explained by near record low payout ratios for US firms. Neither earnings-based nor dividend-based models show the US market to be cheap. Both earnings and dividend-based models show Europe, UK, and emerging markets to now be below fair value.

Pockets of value appearing

Several asset classes, such as high yield credit, now offer a significant margin of safety. While the opportunity set is still limited and not sufficient reason to increase the overall risk score, there are opportunities to selectively increase weights in a selection of asset classes while keeping the overall risk allocation negative.

US dollar to weaken

Current market volatility has seen a flight to safety, leading to dollar strength off already strong levels. We do not expect the dollar to strengthen further and at the first sign of an improving global economy, admittedly not likely in the next few months, we expect to the USD weaken.

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

Tallying up the pros and cons to the market outlook gives a list heavily weighted towards cons. There is still ample reason for a cautious approach.

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

GLOBAL WEALTH AND INVESTMENT VIEW

SA market view and asset allocation – early signs of a slowdown

SA economic data surprising on the upside

The second quarter saw SA GDP growth surprise on the upside again (-0.7% vs consensus of -0.8%). The trade surplus in SA remains strong, and we expect it will continue to be greater than R20bn/month over the coming six months due to still elevated rand commodity prices. Higher commodity prices have also provided stimulus for the SA economy and while nominal GDP growth is low by historical standards at 5%, it is well above the Treasury forecast of +3% for this financial year. Higher-than-expected nominal GDP has led to better-than-expected tax collections for the state. We expect that government revenue this year will be more than R100bn above the February forecast. Credit extension has picked up too, and thos is associated with strong vehicle sales growth.

Early signs of a slowdown in SA

While total tax receipts have been strong, the latest employee tax receipts data point to a slowdown in nominal wage growth in SA over the past couple of months. In addition, recent rate hikes will start to dampen growth in consumption. While we expect SA data to still surprise on the upside, we do not expect strong economic data over the coming 18 months in SA.

SA equity and bonds are cheap

The SA equity market in on a forward P/E of just over 8, less than half of the forward P/E for the US market. The trailing P/E is at a 35% discount to the one-year median vs a 10% discount for aggregate developed markets.

SA bonds offer a meaningful margin of safety too. The slope of the yield curve is abnormally steep both relative to peers and by historical standards. By our calculation, even if the 10-year bond yield moves up by 100bps, the SA 10-year government bond will provide a return similar to cash over the coming year. However, we expect the SA 10-year bond yield to decline over the coming year, leading to an expected return of 10%-15% for the SA 10-year bond over the coming 12 months.

> “We expect that government revenue this year will be more than R100bn above the February forecast”

"The SA equity market in on a forward P/E of just over 8, less than half of the forward P/E for the US market"

SA equity returns to be weak, despite valuation

While the SA market is cheap, and earnings growth is likely to be above 10% over the coming year for industrials and financials, we expect single digit returns from the local equity market. History shows that if the S&P 500 performs poorly, it is unlikely the local market will be able to generate significant returns.

SARB to hike less aggressively than currently priced in

Our model forecast for consumer price index (CPI) inflation in 12 months' time is 4.6%, the Monetary Policy Committee (MPC) forecast is 4.5% and the consensus forecast is 4.7%. Despite widespread expectations of inflation declining materially over the coming year, the forward rates agreement (FRA) market is currently pricing in 10 hikes of 25bps points each over the coming year. That would take the repo rate to over 8%, while inflation is below 5%. We think that is an unlikely scenario and expect 100-125bps worth of increases from the South African Reserve Bank (SARB) over the year ahead, mostly front-loaded.

"History shows that if the S&P 500 performs poorly, it is unlikely the local market will be able to generate significant returns"

Eskom risk elevated

Even under Eskom's base case, SA is likely to experience regular loadshedding over at least the coming year. While companies have found ways to cope with loadshedding either through generators or solar, this comes with a cost and Eskom remains a binding constraint on growth in SA. We do not expect this to change in the next year

Asset allocation:

The committee has reduced its SA risk score to +0.5. We are neutral SA equities and overweight SA bonds.

SA equities: Screen cheap but weak global returns likely to be strong headwind. SA Inc. stocks favoured sector. Neutral.

SA bonds: Screen cheap with support from continuing strong government revenue and the prospect of lower global bond yields. Overweight long-dated nominals.

Cash: Rates still low relative to peers and in an absolute sense, we expect the SARB to hike by 100-125bps over the coming year.

Property: We prefer exposure to SA yields through the government bond market.

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	Q3 2022	Q4 2022	COMMENTS
Global Equity	-	-	GISG score negative. Market screens as expensive with further monetary policy tightening to come. Sizeable earnings downgrades on the horizon too.
Global Fixed Income	N	+	Now a margin of safety in global fixed income, especially US nominal and inflation-linked bonds
Global Cash	++	+	Reducing weight to increase exposure to fixed income. Still overweight given global uncertainty.
Emerging Markets	N	N	EM equities screen as cheap value, in contrast to DM equities.
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	Q3 2022	Q4 2022	COMMENTS
SA Equity	+	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. Government 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. Increase in weight after increases in short rates.
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.
USD/ZAR (+ for ZAR strength)	N	++	USDZAR meaningfully weaker than our estimate of fair value. We expect the 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	Q3 2022	Q4 2022	COMMENTS
Global Plays	N	N	Neutral. Valuation less of a concern than before.
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	+	+	Cheap. SA data continues to surprise on upside.
Small/Mid cap	+	+	Valuations still attractive and investor appetite starting to increase.

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

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