Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q4 2023 – Abundant reasons for caution

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By Chris Holdsworth, chief investment strategist, Investec Wealth & Investment and chair 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.

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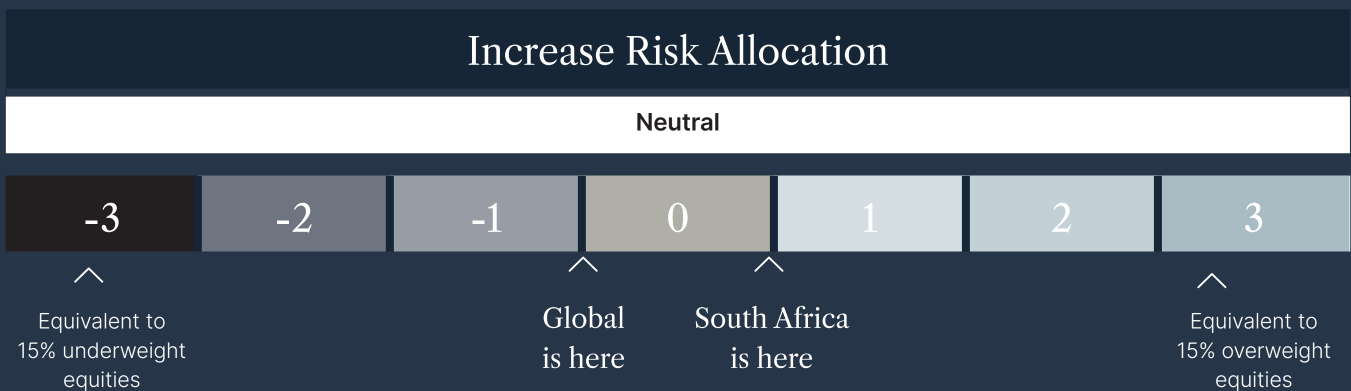
Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Investec Wealth & Investment South Africa. His research covers asset allocation and sector selection, both locally and internationally. Chris comes from the research team in Investec's equity business, where he was an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



Summary

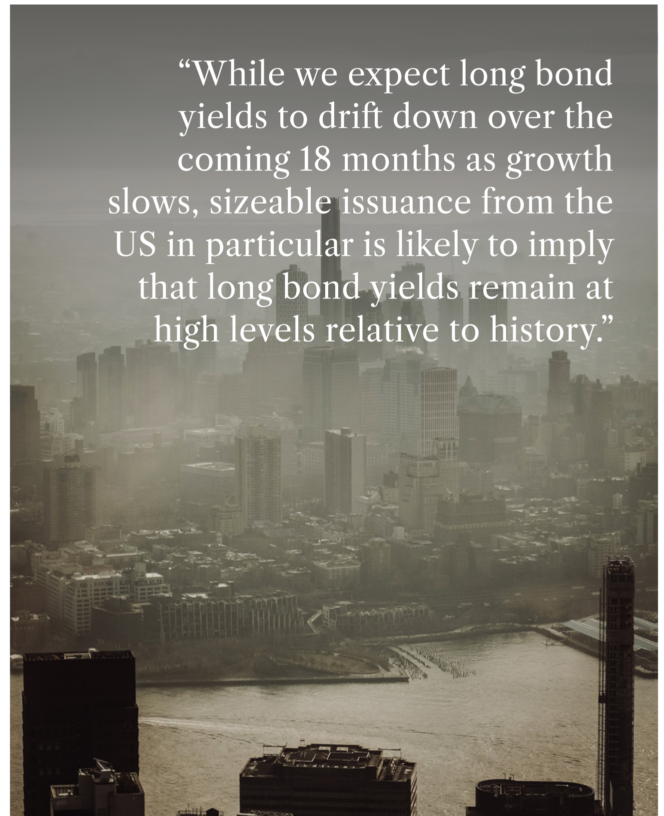
We expect global GDP growth to slow materially over the coming 18 months, with the US likely to enter a recession soon. While this is not too different from the consensus economic forecast, it does imply that earnings will come out well below the current consensus earnings forecast. In addition, the US equity market offers very little margin of safety in our view. Global rates have increased rapidly and we expect they will only drift down – a headwind for both the economy and the market. The GISG global risk score remains at -0.5.

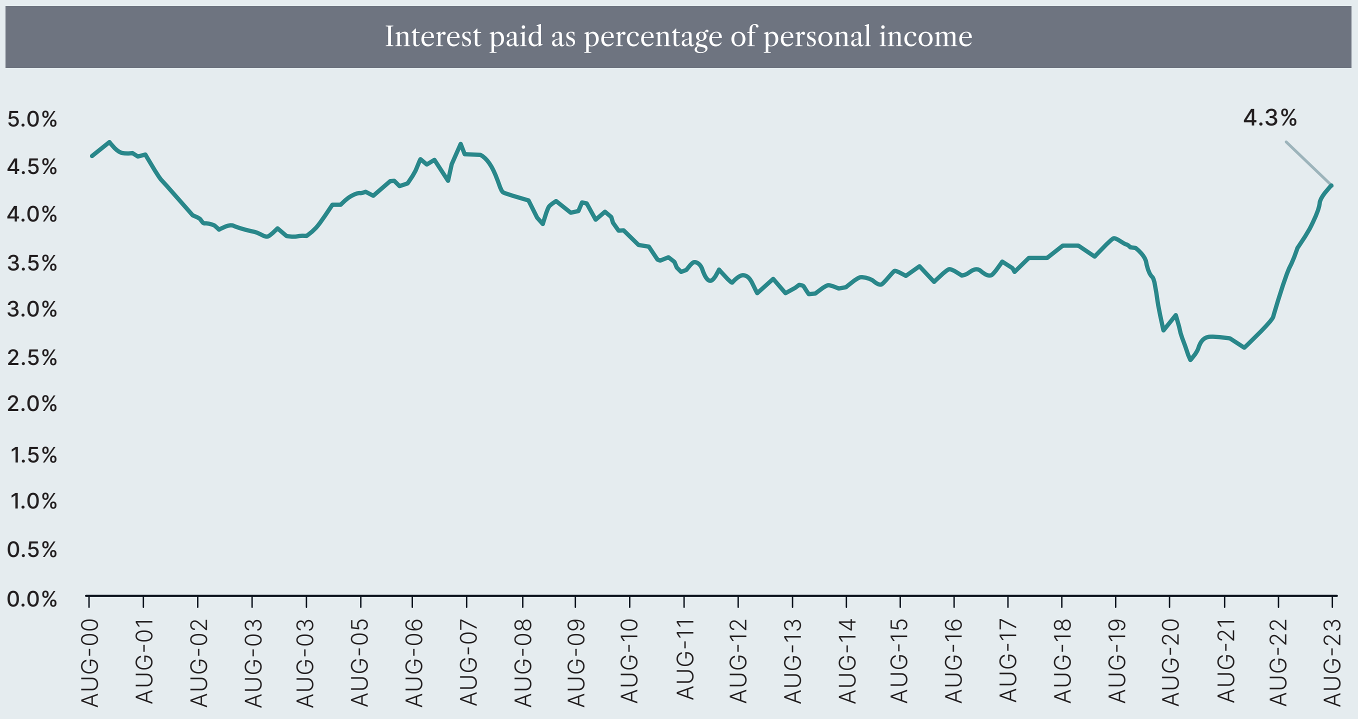
South African equities and fixed income screen as cheap, however. The prospect of reduced loadshedding over the coming year, combined with rate cuts from the SA Reserve Bank (SARB) leads us to retain our overweight 'SA Inc' call. While the election next year increases the risk that National Treasury will be less fiscally prudent than normal, we see sufficient margin of safety in South African bonds to retain an overweight position.

Rationale:

Developed market rates are high – and are likely to stay high for a while. The effective Federal funds rate is at the highest level it has been in 20 years. The European Central Bank (ECB) deposit rate is at the highest level on record since the introduction of the euro. With higher short rates have come higher long bond yields. The US 10-year government bond yield is currently well above 4%. US 10-year inflation linked bonds currently yield over 2%, the highest yield in 15 years. While we expect long bond yields to drift down over the coming 18 months as growth slows, sizeable issuance from the US in particular is likely to imply that long bond yields remain at high levels relative to history. There is also a non-negligible chance that US inflation proves sticky – delaying any Fed response to a slowdown.

High real yields will have an impact on the economy. Elevated real yields will likely curtail new borrowing – with negative consequences for GDP growth. Interest expense as a proportion of disposable income is already at a 15-year high in the US, even though the vast majority of homeowners have fixed mortgages. Even if corporates termed out debt while rates were low, as that debt matures and needs to be refinanced, we can expect interest expense for corporates to trend up over the coming few years.





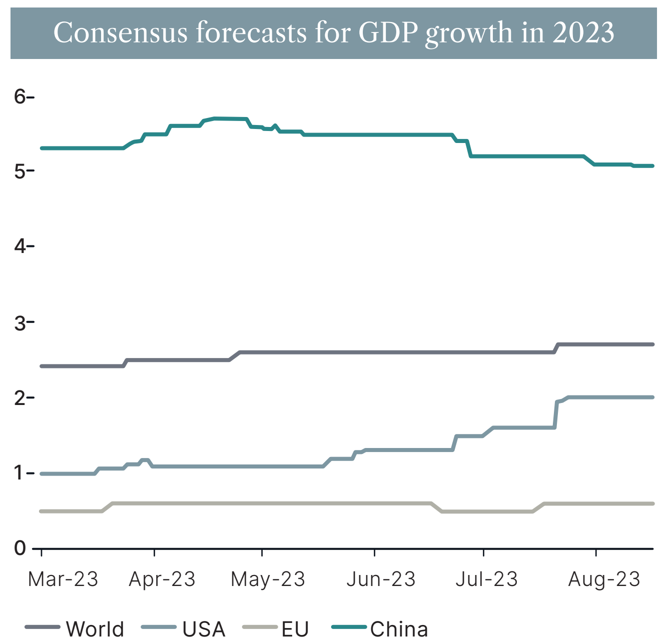
Date sampled:22/09/2023
Source: Investec Wealth & Investment, Bloomberg

High yields will have an impact on the market. Elevated discount rates heighten the risk in the equity market both through equity valuation and by providing an alternative. Both cash rates and fixed income provide significant real returns at spot rates.

Higher rates will have fiscal effects. The surge in developed market yield curves over the past two years will start to have an effect on 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.

US growth has surprised on the upside – and expectations have increased. As a result of surprising economic resilience, the consensus forecast for GDP growth in the US this year has increased to 2%, even as EU growth forecasts have not materially changed and Chinese growth forecasts have been reduced. The resilience of the US economy goes some way in explaining the strong performance of the US market over the past 12 months.

Consensus forecasts for GDP growth in 2023



Date sampled: 13/09/2023
Source: Investec Wealth & Investment, Bloomberg

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

	2021	2022	2023	2024
USA	5.7	2.1	2	0.9
Japan	1.7	1.1	1.8	1
EU	5.2	3.45	0.6	0,85
Germany	2.8	1.9	-0.3	0.8
France	7	2.6	0.7	1
Italy	6.3	3.9	0.9	0.7
Spain	4.8	4.6	2.2	1.5
UK	7.2	4	0.3	0.5
China	8.1	3	5.07	4.5
South Africa	4.8	2.3	0.3	1.3
DM	5.21	2.73	1.48	1.09
EM	6.51	3.06	3.83	4.05
World	5.8	3.1	2.7	2.6

Date sampled: 13/09/2023
Source: Investec Wealth & Investment, Bloomberg

> "The resilience of the US economy goes some way in explaining the strong performance of the US market over the past 12 months."

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.

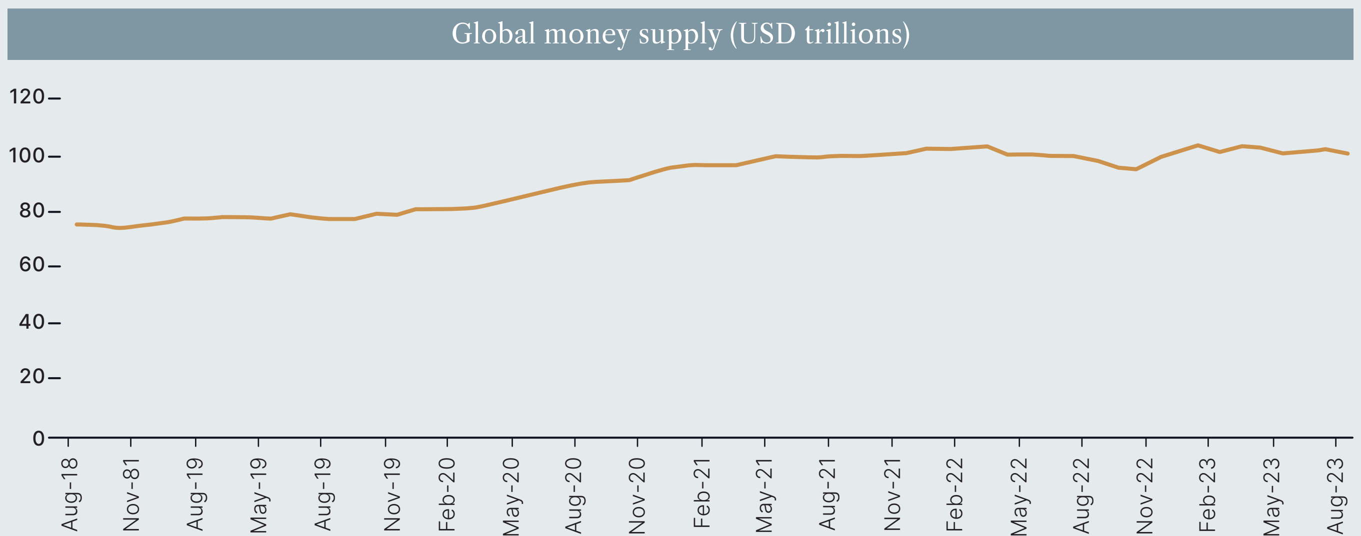
US to go into recession. The leading indicator, the yield curve, consumer expectations relative to current position and defaults all point to a recession starting soon in the US, if it has not already started. The resumption of student loan repayments increases the risk that growth slows sooner, rather than later. 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.

Signs that the US labour market is about to soften. Nonfarm payrolls are tracking close to the average trajectory typically seen after a yield curve inversion. If it continues to follow the post yield curve trajectory, nonfarm payrolls growth will likely stagnate from December to March. Revisions to nonfarm payrolls have been consistently negative. It seems the US labour market is finally starting to weaken – consistent with an imminent start to a recession.

Europe to see weak growth too. We expect that the ECB will 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.

Growth is weak, liquidity levels are low. Global M2 money supply has stagnated – suggesting lower nominal GDP growth ahead. Developed market central bank balance sheets continue to be reduced too. The combination of low levels of liquidity and a weak growth outlook suggests a risk-off position.

> "The leading indicator, the yield curve, consumer expectations relative to current position and defaults all point to a recession starting soon in the US, if it has not already started."



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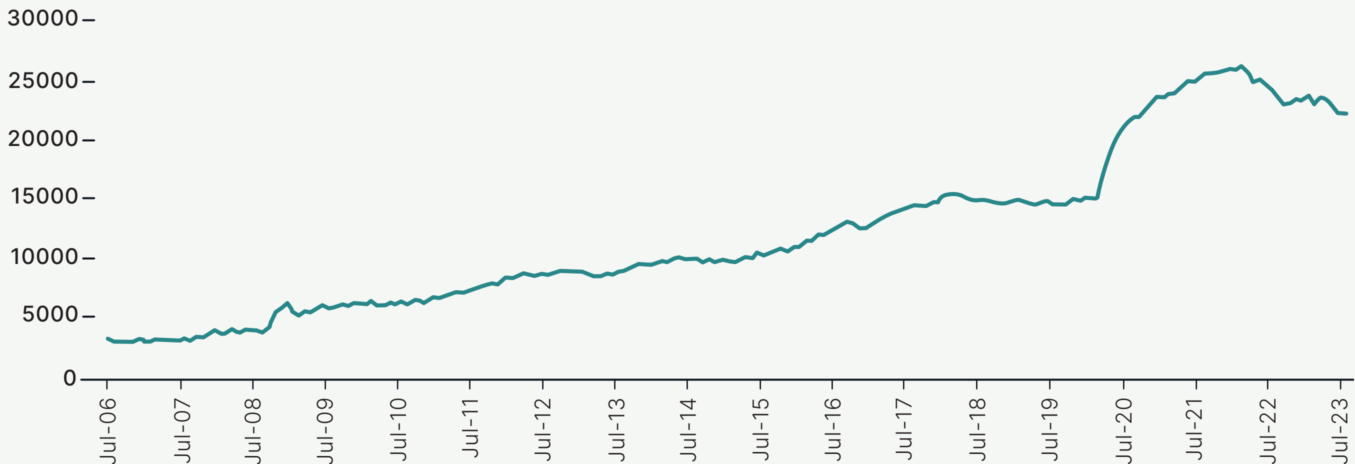
Source: Investec Wealth & Investment, Bloomberg

Fed, ECB, BOJ, BOE balance sheet (USD billions)



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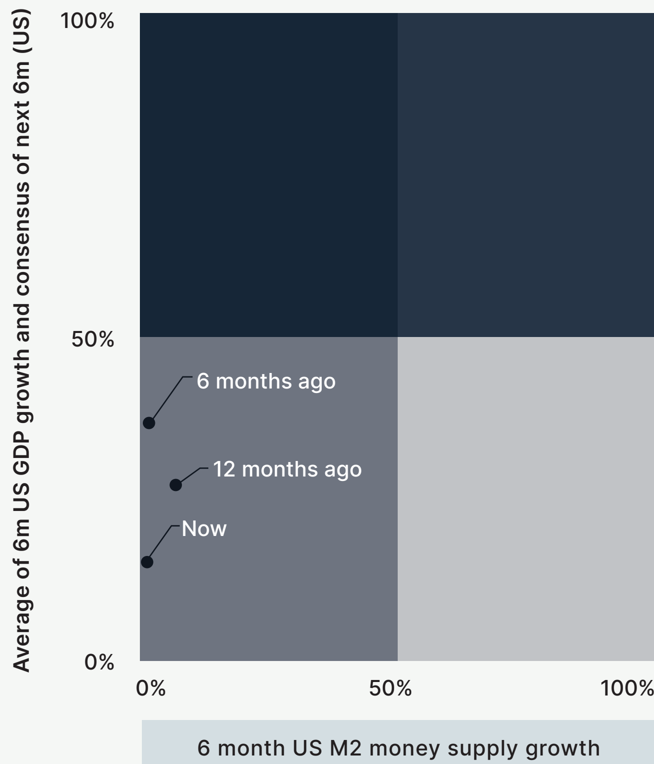
Source: Investec Wealth & Investment, Bloomberg

Percent rank since 1980



Date sampled: 13/09/2023
Source: Investec Wealth & Investment, Bloomberg

"Whichever way one looks at it, the US market is still expensive and offers little margin of safety. Earnings and dividend-based models show Europe, UK, and South Africa to now be at or below fair value."

Chinese data starting to turn. It appears that attempts by the Chinese authorities to spur the economy on are finally having an effect. Recently retail sales, industrial production and total social finance have all surprised on the upside. Inflation in China remains close to zero and PPI inflation is well below zero – implying there is still ample space for further monetary stimulus. There is significant risk however that relations with the West continue to sour – clouding the medium-term outlook for growth.

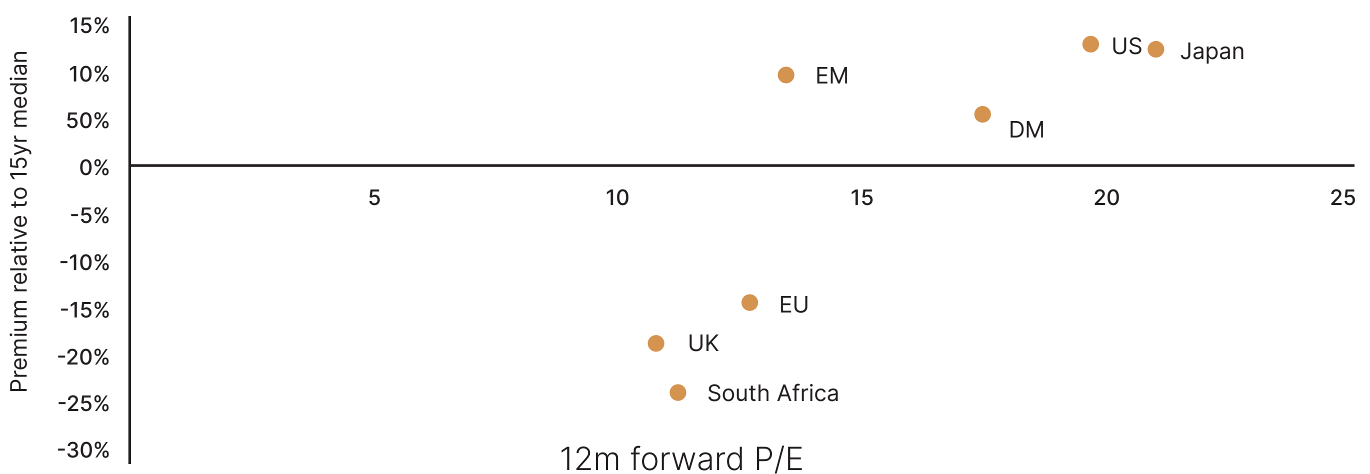
"Inflation in China remains close to zero and PPI inflation is well below zero – implying there is still ample space for further monetary stimulus."

US market is expensive. Our dividend-based model shows the US market to be about 30% overvalued. The HOLT-based implied discount for the US market is still low too. The forward price/earnings ratio (P/E) of the US market is 20, a 15% premium to the 15-year median and we expect earnings to be downgraded. The premium the US trades at relative to Europe is in the top quartile for the forward P/E, price-to-book (P/B) and enterprise value to earnings before interest, taxes, depreciation, and amortisation (EV/EBITDA) ratios. Whichever way one looks at it, the US market is still expensive and offers little margin of safety. Earnings and dividend-based models show Europe, UK, and South Africa 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 its still low inflation rate.

	Premium US trades relative to EU	Percentile relative to history
Investec model	44.6%	100%
Forward P/E	60.5%	97%
P/B	139.3%	85%
EV/EBITDA	49.8%	76%

Date sampled: 22/09/2023
Source: Investec Wealth & Investment, Bloomberg

Valuation relative to peers and history



Date sampled: 02/10/2023
Source: Investec Wealth & Investment, Bloomberg

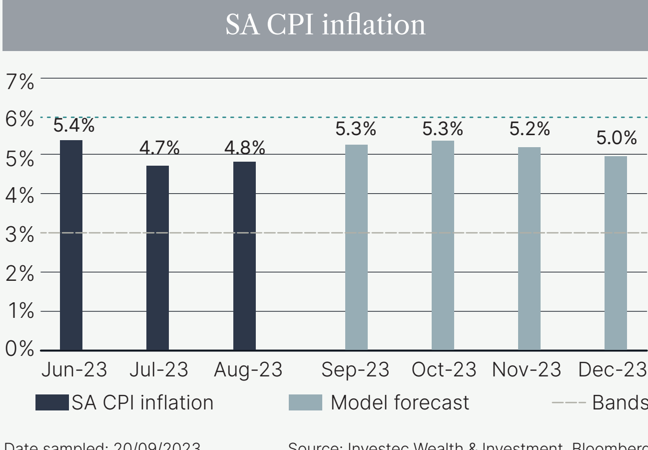
US equities to underperform Treasuries over the coming three and 18 months. The prospect of a US recession and earnings downgrades, with little margin of safety in equity valuations, implies significant chance of the US equity market underperforming Treasuries over the short term. Even over 18 months we expect the US equity market to underperform medium-dated treasuries by up to 10%.

More 'cons' than 'pros' to the market outlook. Tallying up the pros and cons to the global market outlook gives a list heavily weighted towards cons. There is still ample reason for a cautious approach. Having said that, the early part of the cycle is typically the most rewarding – suggesting we should not be too underweight risk.

South African market view and asset allocation – a light at the end of the tunnel?

Not too far from a cut by the MPC. We expect that SA inflation will be within the band for the rest of the year. As in the US, SA monetary policy is the tightest it has been in 14 years. We do not think the SARB's Monetary Policy Committee (MPC) will need to wait for the Fed to cut first – the MPC started to hike before the Fed did in this cycle. We expect the MPC to cut by 75bps (0.75 percentage points) over the coming year. The key risk to this view is the oil price. Should oil continue to rally (unlikely in a global slowdown), then inflation could prove to be stickier than we expect.

SA CPI inflation

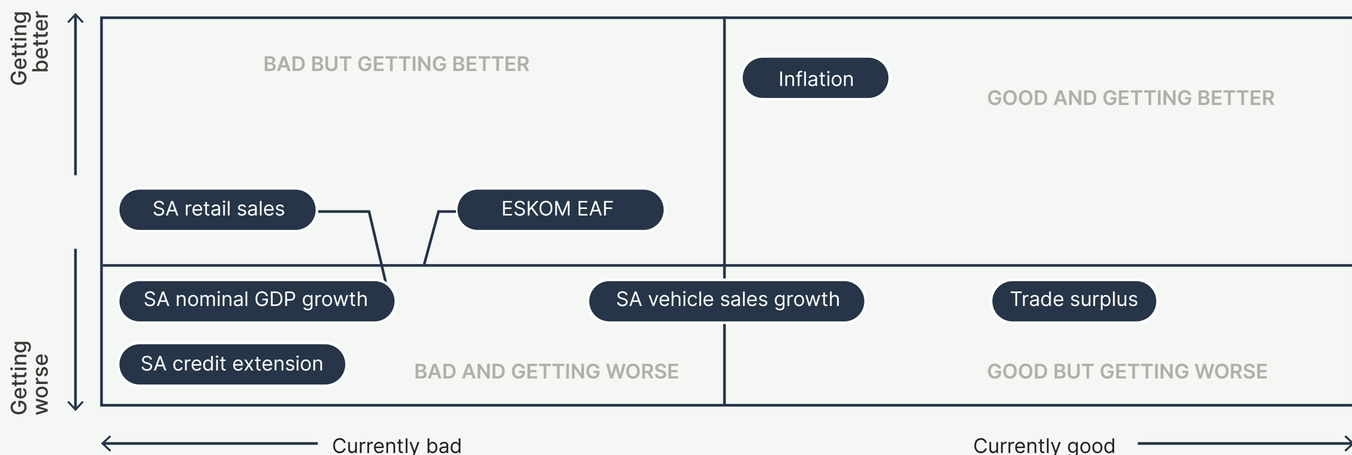


Date sampled: 20/09/2023 Source: Investec Wealth & Investment, Bloomberg

"We expect the MPC to cut by 75bps (0.75 percentage points) over the coming year. The key risk to this view is the oil price. Should oil continue to rally (unlikely in a global slowdown), then inflation could prove to be stickier than we expect."

The South African economy is currently weak but there is a light at the end of the tunnel. The current economic data are weak. Vehicle sales, retail sales, credit extension, nominal GDP growth are all unimpressive. However, inflation has declined swiftly over the past six months and we expect rate cuts to follow shortly, which should provide some relief. In addition, we are probably past peak loadshedding, given the scale of solar imports. 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: 25/09/2023
Source: Investec Wealth & Investment, Bloomberg

"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."

Bonds are our preferred asset class. South African government debt with a maturity above five years seems to carry a significant margin of safety. This is partly true across emerging markets – many emerging markets are seeing 10-year bond yields trade at near record highs relative to inflation while the opposite is true for developed markets. This may be due to developed markets being able to credibly implement quantitative easing (QE). As thwe South African 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 government will temporarily be less fiscally prudent than normal, but with double digit yields we still see value in South African government debt. Even if government bond yields go up by 100bps (one percentage point), which is not our expectation, by our calculation government bonds will give 5% over the year.

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

The rand is likely to strengthen. Even though global growth is likely to slow and South Africa has a litany of economic issues to deal with, we still see value in the rand. Our model estimate of fair value for the rand against the US dollar is around 17.5, even if South Africa is removed from AGOA, and materially stronger if South Africa remains in AGOA.

'SA Inc' is our preferred sector. SA Inc shares 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 South African bonds and equities receive an overweight allocation.

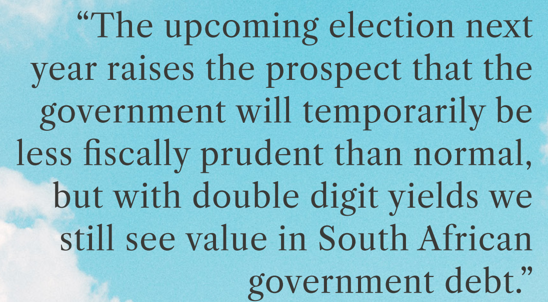
Equities: Screen cheap but weak global returns likely to be strong headwind. SA inc favored sector. Neutral.

Bonds: Screen cheap with prospect of support from lower global bond yields. SA budget shortfall a headwind that is likely to keep yields elevated.

Cash: We expect the SARB to be cutting rates by year end.

Property: Sufficiently cheap to justify neutral position.

Gold: Overweight but looking to reduce and switch into US cash or treasuries.



"The upcoming election next year raises the prospect that the government will temporarily be less fiscally prudent than normal, but with double digit yields we still see value in South African government debt."

"Even though global growth is likely to slow and South Africa has a litany of economic issues to deal with, we still see value in the rand."

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 2023	Q4 2023	COMMENTS
Global Equity	-	-	GISG score negative. Global growth set to weaken with sizeable downside risk to earnings forecasts. US market does not offer suffficent margin of safety.
Global Fixed Income	+	+	Global fixed income 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 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	Q3 2023	Q4 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. Election next year imlies will 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 intertest rates. Utilitiy 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)	+	+	USDZAR materially 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. Rising real yields a concern though. Looking to reduce to neutral.

SECTORAL/THEMATIC POSITIONING	Q3 2023	Q4 2023	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. 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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