Global Investment View

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Upgrading to a positive outlook as vaccines promise “Covid liberation”

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.

Commentary by:

John Haynes

John is Head of the UK Research team, based in London. He is Chairman of the Global Investment Strategy Group and a member of the Asset Allocation Committee. John started his career at Robert Fleming & Co as an analyst and fund manager on the US Equity desk. He then became the first non-founding partner at Taube Hudson Stonex Partners, where he gained experience in European and Far Eastern markets, before joining Investec in 2001. John graduated from Cambridge University with a degree in Chinese and Computer Sciences, and is a CFA Charter holder.

Chris Holdsworth

Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for 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 has been an investment analyst for 12 years, covered investment strategy for six years and has headed up the research team for two years. He is also a member of the Global Investment Strategy Group (GISG).

Upgrading to a positive outlook as vaccines promise “Covid liberation”

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) has increased its risk budget score from neutral to positive (from a score of 0 to 0.5, on a scale of +3 to -3).

The increase in the risk position reflects the GISG view that the fundamentals for risk assets (that is, growth expectations) have materially improved since our last GIV publication. Although the pricing of risk assets looks fair relative to current consensus expectations, near term hurdles aside, we believe the probability of positive surprises materially outweighs the likelihood of negative ones.

We therefore believe that the improved outlook is not fully reflected in the pricing of risk markets, and an attractive spread between risk assets and insurance assets is in prospect.

Covid-19: investment case closed.

Medical science has succeeded beyond our wildest hopes. Multiple effective vaccines are now available or will become available in large quantities early in 2021 across both developed and emerging markets. Enough people are expected to be vaccinated globally for herd immunity, sufficient to allow a worldwide elimination of economic restrictions to be achieved by the middle of 2021.

In the meantime, however, the world is wrestling with a second wave, the human cost of which will remain evident until the vaccination programme ramps up, with some potential for time frames to slip in this enormous and complex logistical exercise. Restrictions will remain in the near term, but should not increase (on an aggregate, economic consumption-weighted basis) in the period between now and the vaccine being rolled out.

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Even before "Covid liberation", economies are tracking an encouraging central case for economic growth.

The past quarter has seen solid economic performance globally, on track with IMF projections, in spite of the fact that the recovery has recently been challenged both by a resurgence of the virus in developed markets, with a consequent tightening of restrictions, and also by the US's reduced fiscal support. The evidence is strong that the fabric of developed market economies has been substantially protected by fiscal measures through the crisis, perhaps to a greater degree than appreciated.

The beginning of a new economic and profit cycle.

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However whatever-it-takes monetary and fiscal policy will likely be with us for the foreseeable future.

2021 should see strongly synchronised global growth, as suddenly liberated animal spirits permeate both consumer and business behaviour.

Risk assets are fairly valued.

Equity markets are no longer cheap by our valuation metrics. However, given the vast amount of global stimulus due to be deployed and central bank commitment to keeping rates lower for longer, we expect equity markets to become expensive, rather than cheaper.

SA market view and asset allocation – Maintaining our position in SA government bonds as the preferred asset class, but with gold for insurance

Overview

The SA asset allocation committee has decided to increase its risk allocation in SA assets following the increase in the global risk score.

Key themes for the quarter:

A weaker US dollar.

It is the view of both the GISG and the SA asset allocation committee that we can expect further US dollar weakness over the coming 12 to 18 months. This is due in part to a global "risk-on" trade and in part due to economic performance in developed markets (ex US) exceeding that of the US. Dollar weakness typically comes with higher commodity prices and rest-of-world equity performance exceeding US equity performance. In addition, a weaker dollar typically sees SA specific factors (e.g. Eskom, the fiscal position etc.) playing a smaller role in determining SA asset class prices.

Global inflation on the up?

United States M2 money supply growth is currently up 25% year-on-year. A number of hard commodity prices are at seven-year highs and global agricultural commodity prices are up 15% year-on-year. Chinese container shipping rates are up 60% and are at an eight-year high. In addition, companies are guiding for higher input costs and have signalled through PMI surveys that they are starting to pass those costs on. We think it is prudent to expect an increase in global inflation over the coming six months at least.

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SA's fiscal position is a constraint.

Even based on Treasury's forecasts, SA nominal GDP growth is unlikely to exceed SA government debt growth until at least 2024. The prospect of a continually rising debt-to-GDP ratio raises concerns about the price of SA government debt. However, the SA yield curve is very steep and it is possible for the government to borrow at far below 9% (the current 10-year rate) by shortening the maturity of new debt issuance.

There is a significant amount of debt to come – R1.4 trillion over the next three years – but it's not unrealistic that nominal GDP grows at a faster rate than the aggregate yield on new debt issued by the state. While SA bonds offer value, it is our view that SA government bond yields are likely to remain elevated (above 8%) for the next 12 to 18 months.

Valuations are supportive.

By our estimate, the rand is at fair value. However, the prospect of a rising tide driven by dollar weakness and flows into emerging markets means it could well strengthen further. SA equities are pricing in a return on invested capital over the next five years that is lower than the returns generated last year. We think this is too pessimistic. SA bonds screen cheaply by the valuation tools we use, but given the issuance that is likely to come to the market over the next four years we think there is little scope for SA long bond yields dropping below 8%.

Asset allocation:

SA bonds: The committee retains an overweight position, due to valuations. SA bonds screen cheaply relative to peers, relative to history and relative to cash. However, the team has decided to make an increased risk allocation to SA equities rather than bonds, given the prospect of large government bond issuances to come.

Equities: The committee has increased the SA equity allocation primarily on the back of valuation vs other emerging markets. We estimate that the risks to this view are SA specific and as a result, we have retained an overweight allocation to gold, which should provide a hedge against SA-specific risk.

Cash: At spot rates, the committee thinks cash is unattractive, especially with the prospect of higher inflation ahead. The underweight position is retained.

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Property: while the committee remains concerned about several issues in the property space (e.g. oversupply in the commercial space) we have slightly narrowed its underweight position ahead of a vaccine roll out in SA. The nature of the sector is still very different from the pre-Covid period.

Our checklist for risk preference in SA:

- Sustained risk-on appetite globally
- Resumption of emerging market outperformance versus developed markets (from a growth and earnings perspective)
- Coherent plan on how to deal with Eskom and other SOEs – a strong message is needed on how expenditure will be controlled. The current situation is unsustainable
- No more load-shedding from Eskom – this was a major constraint to growth in the first quarter
- More clarity on government policy, given the factionalism within the ruling party.
- Interest rate cuts – other central banks (including emerging markets) are cutting rates. SA's real interest rate is extremely high in this context and there is ample room to cut. SA risk assets typically perform well in a downward interest rate environment
- Improvement in business confidence – unlikely to see job creation unless this improves

Our overall positioning is summarised in the table below:

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	Q4 2020	Q1 2021	COMMENTS
Offshore Equity	N	+	Vaccine deployment sees the start of a new economic cycle. Market no longer cheap but vast stimulus being deployed.
Offshore Fixed Income	-	-	Developed markets bonds offer little value in our view. We see material upside risk to global bond yields. US inflation to breach 2% by May.
Offshore Cash	+	N	Neutral to allow for greater risk allocation should it be required.
Offshore Property	N	N	Valuations reasonable relative to long term averages.
Offshore Alternatives	+	+	Offers attractive risk-adjusted returns relative to traditional long only assets classes. Variations include return enhanced, capital protected and low correlation products.

SA ASSET ALLOCATION	Q4 2020	Q1 2021	COMMENTS
SA Equity	-	+	Improving emerging markets tailwinds should benefit local equity market. Market cheap relative to emerging markets and developed markets peers.
SA Fixed Income	+	+	Still significant margin of safety in SA debt in our view.
SA Cash	-	--	We prefer to be exposed to the longer end of the curve and use gold as an insurance asset.
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.
Preference Shares	+	+	Very strong performance has moved valuations close to fair value. Still attractive for investors looking for after-tax income.
$/R (+ for ZAR strength)	+	+	Weaker dollar and emerging markets tailwinds should see the rand strengthen further beyond PPP fair value (15.5).
Physical Gold	++	++	Allocation to physical gold offers protection against SA and global risks particularly the risk of higher inflation down the line.

SECTORAL/THEMATIC POSITIONING	Q4 2020	Q1 2021	COMMENTS
Global Plays	+	N	Neutral, preference for overweight in SA play and commodity stocks.
Commodities	+	+	Favoured sector to play a global recovery and hedge SA risk.
Precious Metals	-	-	Precious metal producers offer a hedge against SA risk and leverage to a global recovery and weak rand.
SA Plays	-	+	SA inc should benefit from emerging markets recovery and stronger rand. Still cheap in our view.
Small/Midcap	+	+	Valuations still attractive and investor appetite starting to increase.

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