Investec
Wealth & Investment

# Global
# Investment View

Quarter 2, 2021

## The case for SA Inc

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## Positive outlook retained; the risk now is to underestimate, not overestimate, the bounce back

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:

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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 was an investment analyst for 12 years, covered investment strategy for six years and headed up the research team for two years. He is also a member of the Global Investment Strategy Group (GISG).

# The Global Investment Strategy Group (GISG) has retained its positive risk budget score (at 0.5, on a scale of +3 to -3)

**By Chris Holdsworth, chief investment strategist, Investec Wealth & Investment and member of the Global Investment Strategy Group**

Fundamental developments since the January meeting have been almost exclusively positive: a calmer tone to the US Presidency, the passage of a supplementary major stimulus package, solid global economic data and, most importantly, increasing evidence that medical science is in the process of defeating Covid-19 as an economic threat. The global economic growth outlook is therefore extremely positive in our 18-month investment time horizon, with a cycle peak likely to be substantially beyond that.

Set against this, we acknowledge that the pricing of risk assets is now extended relative to current consensus expectations, and this is likely to lead to near-term setbacks, prompted almost certainly by negative surprises on inflation (that is, higher than forecast). However, we believe we should focus on the longer term, as exceptional earnings momentum puts a rapidly rising floor under equity markets, should they take fright in the face of rising market (as opposed to policy) interest rates. Over 18 months, we see equities delivering mid to high single digit returns in US dollars, but medium-duration fixed income assets are likely to be at best flat, so a tilt towards risk assets remains our recommended stance. This outlook supports market leadership by cyclically sensitive sectors.

**Key highlights of our positioning:**

### Covid-19 – the investment case remains closed

In under three months, vaccinations have been given to over 5% of the world's population, although the multi-shot regimen of most means that perhaps 3% have been fully vaccinated. The efficacy of all of the vaccines in the field is matching that predicted in the laboratory, with (universally) extremely high success at the prevention of progress into severe (hospitalised) Covid-19, albeit that the protection against infection is more dependent upon the strain.

This, combined with strong evidence (from Israel) that vaccination with the novel mechanism (mRNA) vaccines that comprise the vanguard of the treatments, is also effective at reducing transmission, is key to unlocking the developed market economy.

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### Economies are tracking an encouraging path

The world economy has delivered positive surprises even relative to the central case expectations that had embraced a recovery, made by global economic authorities (the OECD, the IMF and the World Bank) at the end of last year. This has been due to highly effective fiscal support throughout developed markets, impressive supply chain adaptability that has offset the tightening of restrictions in Europe, resilient consumer behaviour in the US in the face of political uncertainty and challenging weather patterns, and a strong recovery in China, which benefits emerging markets as well.

### The risk is to underestimate, not overestimate, the bounce back

The resilience of manufacturing and retail sales supports the optimistic assertion that the damage to employment and growth is largely limited to capital-light industries that sell time (the social economy). These industries can gear up (re-hire) quickly when demand reappears.

As the service sector opens up in the second half of the year, 2021 will see a geographically widespread, closely synchronous (almost simultaneous) release of pent up spending power.

### The beginning of a new economic and profit cycle

2021 will therefore see strongly synchronised global growth, as suddenly liberated animal spirits permeate both consumer and business behaviour. Robust employment and investment growth, accompanied by whatever-it-takes monetary and fiscal policy, will be with us for the foreseeable future.

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### Risk assets are now expensive

The rise in US 10-year bond yields from 1.1% in January to just over 1.6% today, is the primary factor that has pushed our touchstone valuation measure into expensive territory (based on historic dividends, which we believe are the best measure of the long-term normalised earnings power of equity markets, discounted by current risk free rates). Using the US as a proxy, global share markets are now 20% above fair value (the fair value range is about 20%), compared with 8% above fair value in January. These readings are more reasonable if there is good reason to believe that earnings and dividends will grow unusually quickly and /or they are underestimated.

Coming from a depressed base, in the context of synchronised global growth outlined above, both are likely. Using reasonable forward-looking estimates of dividend growth of 10% relative to 2019 by the middle of 2022 (in the context of approximately 15% earnings growth over the same period), then fair value for the equity market, assuming no change in bond yields, is around 10% below current equity market levels.

# SA market view and asset allocation – Position maintained, SA consumer recovery appears to be underway

**Overview**

The SA asset allocation committee has kept its risk score at 1, with an overweight position in SA assets in particular.

**Key themes for the quarter:**

### The outlook for inflation

US 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% year-on-year 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.

### The outlook for commodity prices

Nearly all of the commodities we track are up year-on-year, with broad commodity price indices up 60% and around 15% off record highs. However, total social financing growth has picked up again in China, indicating a further increase in demand for commodities over the coming nine months. Unlike in previous cycles, commodity producers have been disciplined in the face of higher commodity prices and have not ramped up expansionary capex. The net result is that the committee believes that commodities have further to run.

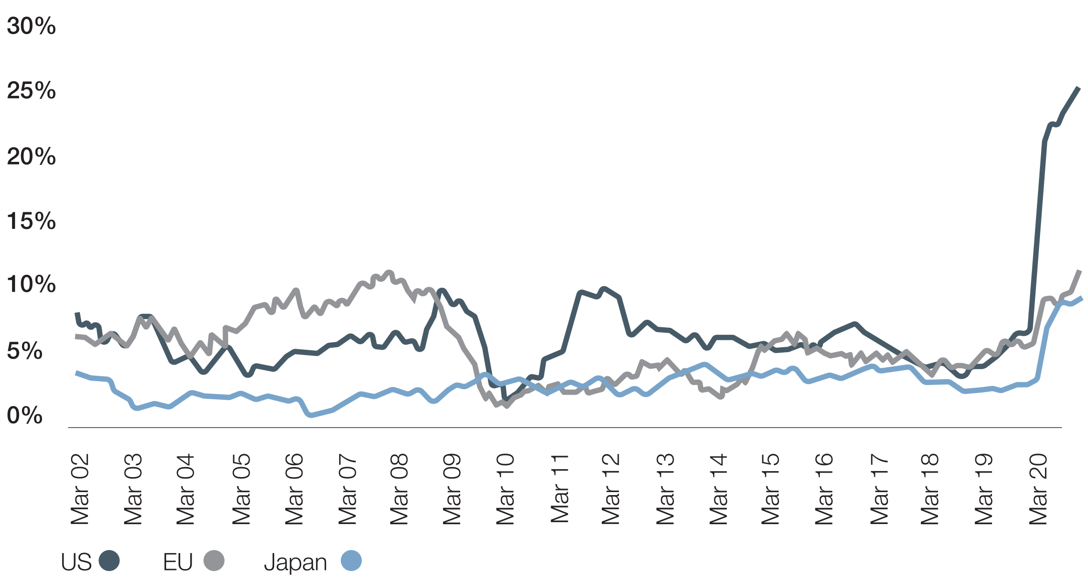
### A recovering SA consumer

Employee tax receipts, GDP data for the fourth quarter of last year and retail sales data for December all point to a recovery in aggregate consumer incomes, to pre-Covid levels by the end of last year. Business confidence is already above pre-Covid levels, signalling an improvement in employment over the coming 12 months. SA consumers typically access more credit and buy more durable goods as incomes pick up. We do not expect this time to be different (see separate article for more on this topic).

### SA bonds:

SA bonds screen cheaply relative to peers, relative to history and relative to cash. However, we think that SA equities will deliver more over the coming 12 months and will look for opportunities to reduce our overweight in SA bonds, in favour of equities, while remaining overweight in bonds.

**yoy M2 money supply growth**




23/03/2021 *Source: Refinitiv, Investec Wealth & Investment*

**Unlike in previous cycles, commodity producers have been disciplined in the face of higher commodity prices and have not ramped up expansionary capex.**

**Equities:**

We continue to be overweight SA equities. The SA equity market is pricing in an abnormally low return on invested capital over the coming five years – abnormal that is, relative to history and peers. SA Inc and the diversified commodity producers screen as particularly cheap and we expect them to outperform the broader index, given our macroeconomic view.

**Cash:**

At spot rates, we think cash is unattractive especially with the prospect of higher inflation ahead. We remain underweight.

**Property:**

While we remain concerned about several issues in the property sector (e.g. oversupply in the commercial space), we have slightly narrowed our underweight position ahead of a vaccine roll out in SA.

**Our checklist for risk preference in SA:**

1. Sustained risk-on appetite globally

2. Resumption of emerging versus developed market outperformance (from a growth and earnings perspective)

3. A coherent plan on how to deal with Eskom and other state-owned enterprises – we need a strong message on how the expenditure will be controlled. The current situation is unsustainable

4. No more load-shedding by Eskom – this was a major constraint to growth in the first quarter

5. More clarity on government policy, given the factionalism within the ruling party

6. Interest rate cuts – other central banks (including emerging markets) are cutting rates. Our real interest rate is extremely high in this context and we have ample room to cut. SA risk assets typically perform very well in a downward interest rate environment

7. Improvement in business confidence – we are unlikely to see job creation unless this improves

**Our positioning is summarised in the table below:**

**SA Inc and the diversified commodity producers screen as particularly cheap and we expect them to outperform the broader index, given our macroeconomic view.**

# 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 2021 | Q2 2021 | COMMENTS |
|---|---|---|---|
| Offshore Equity | + | + | Vaccine deployment sees the start of a new economic cycle. Market not cheap but vast stimulus being deployed. |
| Offshore Fixed Income | - | -- | Developed market 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 | 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 | Q1 2021 | Q2 2021 | COMMENTS |
|---|---|---|---|
| SA Equity | + | + | SA equity market is fair value to cheap, with potential for both multiple expansion and increased earnings growth. |
| SA Fixed Income | + | + | Still significant margin of safety in SA debt in our view, however looking to reduce bond exposure in favour of equities when opportunity presents. |
| SA Cash | -- | -- | We prefer to be exposed to the intermediate of the curve and use gold as an insurance asset. |
| SA Listed Property | - | - | Sector to be driven by progress in reducing Loans-to-value and roll-off of Covid-related impacts. Have been reducing underweight. |
| Preference Shares | + | + | Have seen some re-rating of preference share valuations but still attractive by historical standards. |
| $/R (+ for ZAR strength) | + | + | Weaker US dollar and emerging market 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 | Q1 2021 | Q2 2021 | COMMENTS |
|---|---|---|---|
| Global Plays | N | 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 | - | - | We have been increasing allocations on attractive cyclical and structural backdrop. |
| SA Plays | + | + | SA Inc should benefit from the emerging market recovery and stronger rand. Still cheap in our view. |
| Small/Midcap | + | + | Valuations still attractive and investor appetite starting to increase. |

# The case for SA Inc

**by Chris Holdsworth, Chief investment Strategist, Investec Wealth & Investment SA**

**A recovery in SA consumer activity looks to be under way. Such a recovery however does not appear to be fully priced into JSE-listed shares whose fortunes are tied to those of the consumer, however.**

There is no shortage of reasons to justify being cautious about the outlook for domestic consumption expenditure over the year ahead. Eskom is a binding constraint on growth and will likely continue to put a handbrake on growth for some time. Domestic politics is murky at best and there are many unanswered questions regarding the sustainability of a suite of state-owned enterprises.

However, there are some strong mitigating factors that are worth highlighting. There may well be light at the end of the tunnel for consumer spend over the coming year, as we discuss below:

### Incomes have recovered

There are several data points suggesting that SA consumer incomes are back at pre-Covid levels. Employee tax receipts were up year-on-year in December. Data GDP release for the fourth quarter of 2020 suggest that total nominal wages were flat year-on-year in the fourth quarter; meanwhile retail sales were up 1.6% year-on-year in December.

The data for January was a bit weaker, as was to be expected after the renewed lockdown. If incomes had already recovered by December, then we can expect further growth over the year ahead, as vaccines are rolled out and lockdowns become less frequent and severe.

### Business confidence has picked up

Both the SACCI Business Confidence Index and the BER Business Confidence Index are up year-on-year. These changes in business confidence are a key leading indicator for changes in private sector job creation. Given this strong rebound in business confidence, we can expect reasonably strong job creation over the coming 12 months, further aiding aggregate consumer income.

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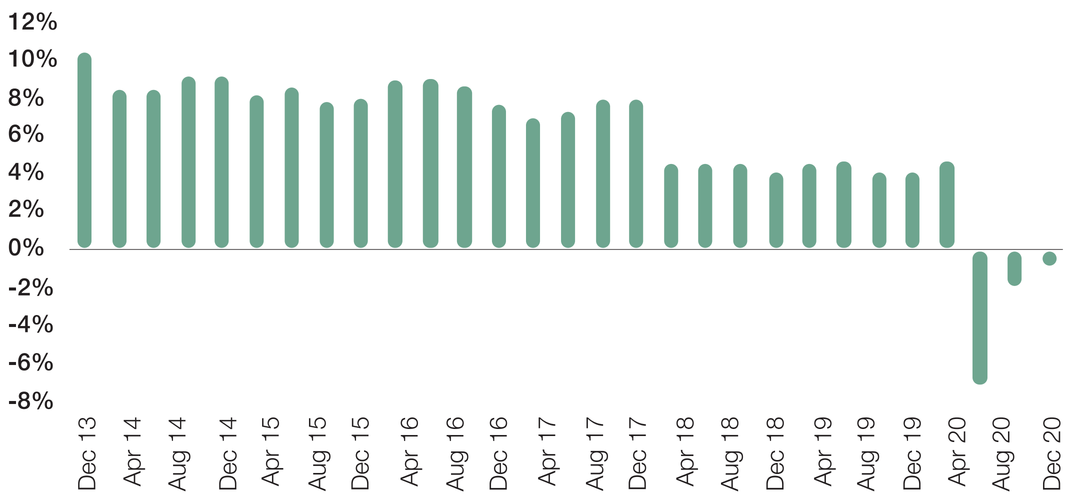
**Employee Compensation (yoy%)**

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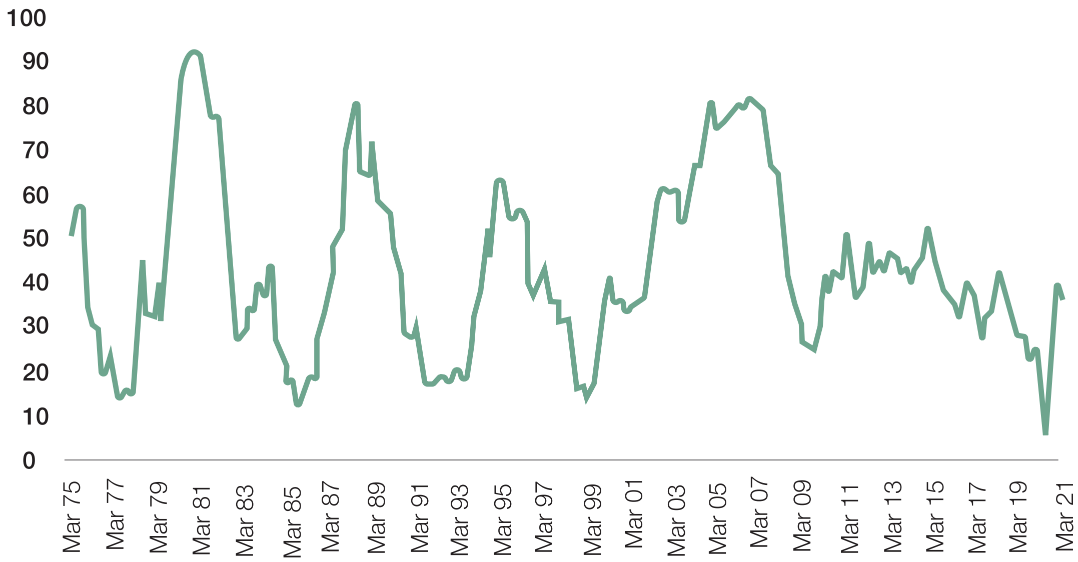
*Source: Refinitiv, Investec Wealth & Investment*

BER business confidence survey

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*Source: Thomson Reuters*

### A change in approach by National Treasury

According to the February Budget, government revenue surprised on the upside by around R100bn. Part of the excess was used to reduce taxes for consumers by raising personal income tax brackets by more than inflation. Most importantly though, National Treasury highlighted that personal income tax in SA was high relative to peers, and hinted at the possibility of further tax relief for consumers over the coming years. This marks a shift in approach from previous years: personal income tax had been increased in five of the six years prior to the latest Budget.

### Interest rates are at record lows

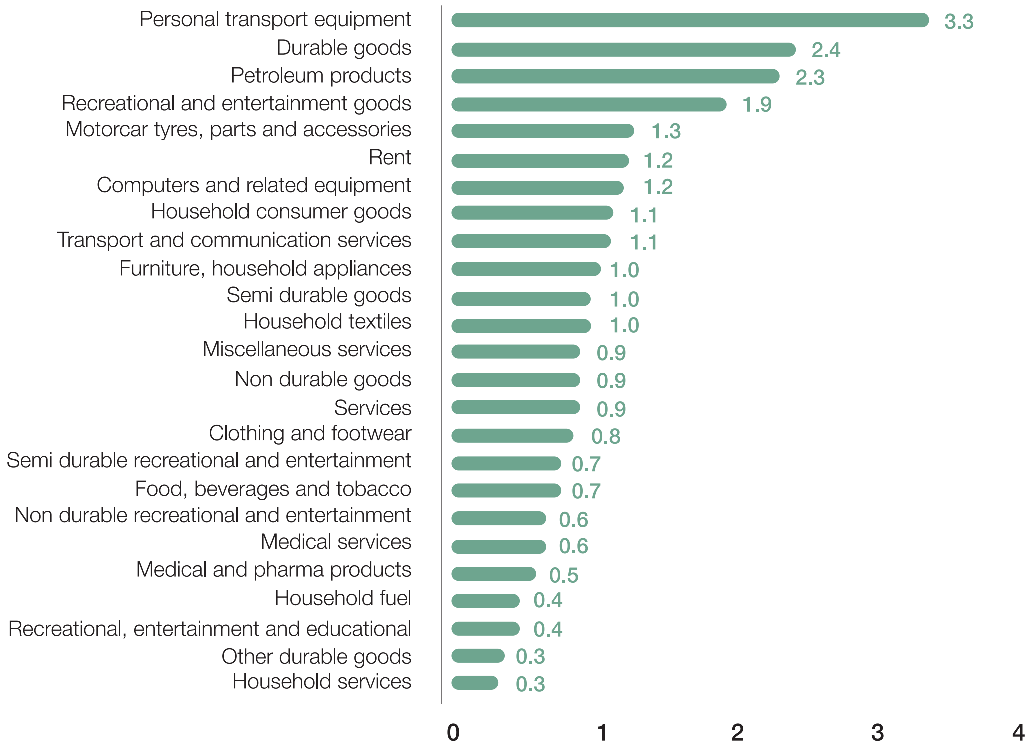
The SA Reserve Bank cut rates aggressively in response to the Covid-19 crisis and we do not expect to see any increases anytime soon. Inflation is likely to pick up shortly in SA – we expect the May print to be over 5% – but given the large output gap in SA and inflation that is still likely to be within the 3% to 6% band over the foreseeable future, we expect that rates will remain at record lows.

Putting it altogether, there are reasons to expect SA consumer incomes to pick up over the coming 12 months and for expenditure to follow suit. The question then is: what will SA consumers buy?

To answer this question we can rely on data from the SA Reserve Bank that breaks down annual consumer spending into its sub components. The data goes back to 1946 but the last 20 years of data is probably more representative of currently likely behaviour than the older data. If we regress changes in real expenditure of each subcomponent against changes in total real expenditure over the past 20 years we get the picture below.

**Given this strong rebound in business confidence, we can expect reasonably strong job creation over the coming 12 months, further aiding aggregate consumer income.**

**Sensitivity of changes in real expenditure in each sector to changes in total real expenditure**




23/03/2021 *Source: Investec Wealth & Investment, SARB data*

The coefficient for personal transport equipment is 3.3, meaning that if total expenditure grows by 10%, expenditure on cars, bikes etc. grows by 33%. More broadly, expenditure on durables is a high beta play on increases in expenditure (that is, when expenditure rises, expenditure on durables rises by more). Semi-durables are less sensitive with a beta of 1, while non-durables and services have a slightly lower beta, at 0.9.

In summary, we expect that SA consumer expenditure will pick up meaningfully over the coming 12 months and durable goods retailers (cars, furniture etc) will be the largest beneficiaries. It is our view that the recovery in consumer activity over the coming 12 months is not fully priced into SA Inc shares, particularly those that are geared plays on SA consumers.

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