Investec

Wealth & Investment

OUT OF THE ORDINARY

# Global Investment View

*Q2 2024 – Global election uncertainty rises*

# Contents

By Chris Holdsworth, chief investment strategist, Investec Wealth & Investment International 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 18 months, setting a risk budget and identifying some of the potential icebergs that lie in the global investor's path.



## Chris Holdsworth, CFA

### Chief Investment Strategist, Investec Wealth & Investment International

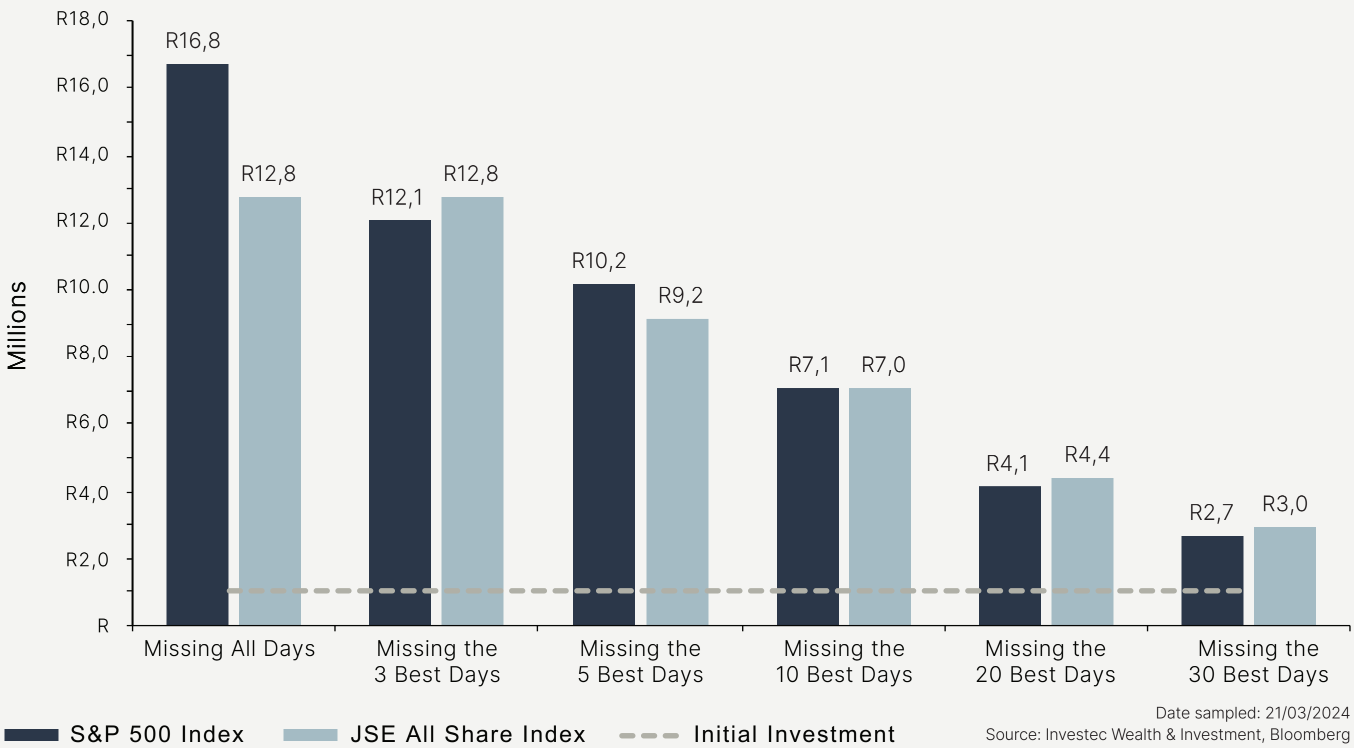
Chris Holdsworth joined Investec in 2007 and is the Chief Investment Strategist for Investec Wealth & Investment International. His research covers asset allocation and sector selection, both locally and internationally. Chris comes from the research team in Investec's equity business, where he was an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

# FOREWORD:
## *Staying invested - A human story*

Peter Lynch, the well-known investor, and author, once said: "Far more money has been lost by investors trying to time corrections than in the corrections themselves." Arguably, one of the greatest challenges of being a wealth manager is helping clients see this and stay invested.

Last year saw the return of positive (after inflation) rates on cash deposits in developed markets, after years of being zero or negative. Naturally capital flowed into cash. However, last year also illustrated how important it was to stay invested in the market. For example, if you had sold your equity market investments last year and switched into cash you would have missed the rally in global equity markets at the end of the year that provided two years of cash returns in two months. History shows that market returns usually occur in a series of hard-to-time bursts.

Below is an example of this. It shows how an investment of R1m would have grown if an investor had remained invested in the JSE All Share Index or the S&P 500 Index (total return in South African rands) for the last 20 years (31 January 2004 to 31 January 2024), instead of trying to time the market by disinvesting and reinvesting and thus missing some of the best days on both the indices.




Date sampled: 21/03/2024
Source: Investec Wealth & Investment, Bloomberg

To illustrate the point, the tables below show the 10 best days for the two indices in rands (the hard-to-time bursts referred to):

| Top 10 Days for the S&P 500 Index | |
|---|---|
| 16 Oct 2008 | 14.3% |
| 13 Nov 2008 | 10.1% |
| 13 Oct 2008 | 10.1% |
| 24 Mar 2020 | 9.1% |
| 09 Aug 2011 | 9.0% |
| 13 Mar 2020 | 8.7% |
| 28 Oct 2008 | 8.3% |
| 20 Oct 2008 | 7.3% |
| 30 Sep 2008 | 6.7% |
| 26 Mar 2020 | 6.6% |

| Top 10 Days for the JSE All Share Index | |
|---|---|
| 24 Mar 2020 | 7.5% |
| 08 Dec 2008 | 7.1% |
| 25 Nov 2008 | 6.7% |
| 29 Oct 2008 | 6.7% |
| 20 Mar 2020 | 6.1% |
| 19 Mar 2009 | 5.8% |
| 19 Sep 2008 | 5.5% |
| 30 Oct 2008 | 5.4% |
| 25 Mar 2020 | 5.3% |
| 24 Jan 2008 | 5.3% |

Date sampled: 31/01/2024
Source: Investec Wealth & Investment, Bloomberg

Staying invested during periods of uncertainty can be hard, because of the powerful elements at play. In the early 2000s, Daniel Kahneman, a psychology professor at Princeton, published research that demonstrated "repeated patterns of irrationality, inconsistency, and incompetence in the ways that human beings arrive at decisions and choices when faced with uncertainty". His research has contributed heavily to the field we now call behavioral finance.

Overconfidence bias or loss aversion are examples of behavioral drivers of trying to time the market, despite the evidence of the adage of "time in the markets, not timing the markets".

Creating awareness of these behaviors and using thorough planning to create what we call mental accounting, can help mitigate these risks. Mental accounting is having different investments allocated to different time frames/needs. For example, you might keep cash or near cash investments for short-term drawing requirements, and to provide a buffer to weather the market volatility that affects your other funds. You also need to consider your values such as family, health, freedom and work (to name a few), and being in alignment with these and your long-term goals.

In addition to psychological responses, there are also physiological considerations. We need to navigate our nervous system responses to uncertainty.

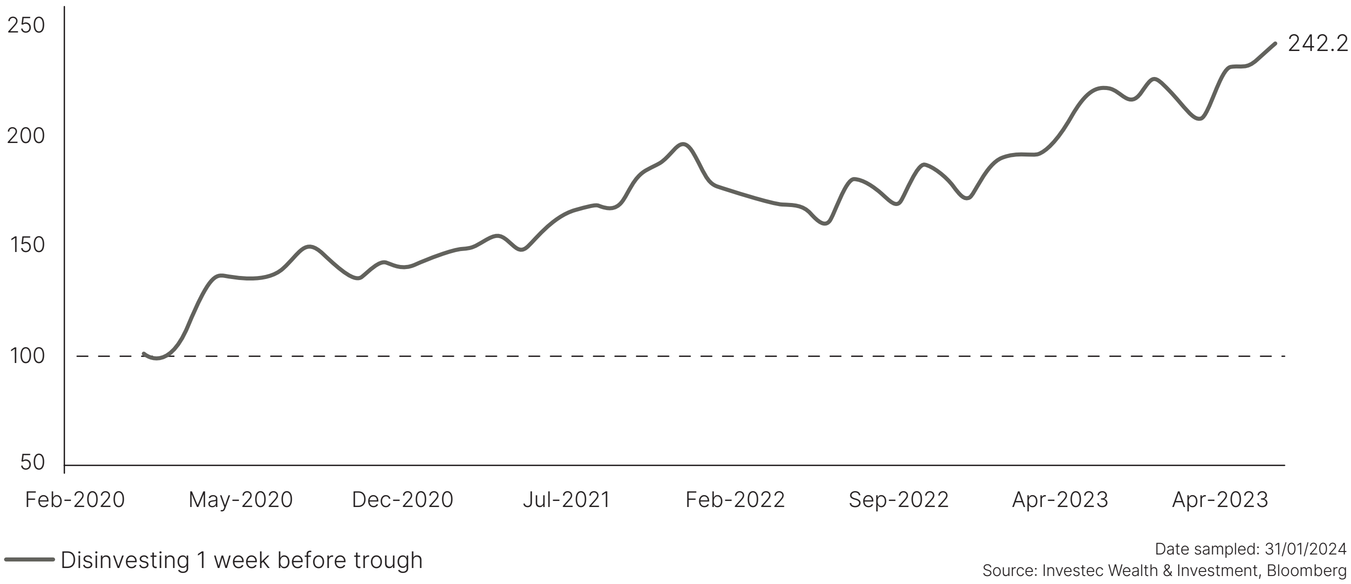
Much of our time spent with our clients is on trying to better understand their reactions and plan for them.

Uncertainty in markets can trigger our nervous system and brain. Instead of our prefrontal cortex (our seat of higher order thinking) making decisions, our amygdala (seat of emotion) takes over.

In his book, "The body keeps score", Bessel Van Der Kolk outlines the fight, flight or freeze responses that the human nervous system uses to protect itself during times of perceived threat.

A flight response for example would be withdrawing money from the market during a crisis. The nervous system becomes so triggered by what it perceives as a threat that it becomes unbearable for the person. The Covid-19 pandemic was a good example of such a situation. Many investors became understandably triggered by the heightened level of uncertainty during that time and sold out of their investments at the bottom, thus missing the recovery that followed:

## S&P 500 total return in South African rands




Date sampled: 31/01/2024
Source: Investec Wealth & Investment, Bloomberg

History has shown that remaining invested and managing risks (including behavioural) are preferable to selling out or staying uninvested. Uncertainty is always present to a greater or lesser degree. Currently, there are major conflicts occurring in the Ukraine and in Israel, China is threatening Taiwan and half the world's population is going to the polls.

It is normal and human to feel destabilised or anxious at times.  However, with that awareness, we can pause, breath, put our shoulders back, regulate and stay invested.

Marc Romberg & Ali Nortier
Joint Heads of Wealth Management

# The GISG maintains its global risk budget score at -1 on a scale of +3 to -3, while the SA risk score has 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*

US GDP growth forecasts have been materially upgraded, even as growth forecasts for the rest of the globe have remained stable. The current consensus forecast of 2.2% seems optimistic and we expect to see downward revisions over the coming few months.

Inflation has surprised on the upside across the globe, and we expect it will continue to do so – raising the prospect of fewer-than-expected rate cuts by the Fed.

In addition to the concerns above, the US market screens as expensive both relative to peers and relative to history.

While the rolling out of artificial intelligence (AI) may mean that margins prove sticky, we still expect downward revisions to earnings growth over the year ahead. The net result is we remain risk off globally.

We see South Africa as offering opportunity and we are overweight South African fixed income. However, given the uncertainty around the election in May, our overweight position is relatively modest. We will look to increase our overweight should there be a market dislocation in the wake of the election.

# *Rationale:*

**Growth is slowing.** Even after significant upward revisions to US growth expectations, the US economy is set to slow this year and next.  We expect that while the US will likely avoid a recession, Europe will not be as fortunate. Post revisions, the consensus US 2024 GDP growth forecast, at 2.2%, seems optimistic, raising the prospect of GDP misses over the year ahead.

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

| | 22 | 23 | 24 | 25 |
|---|---|---|---|---|
| USA | 2.1 | 2.5 | 2.2 | 1.7 |
| Japan | 1.1 | 1.9 | 0.7 | 1.1 |
| EU | 3.45 | 0.5 | 0.5 | 1.3 |
| Germany | 1.9 | -0.1 | 0.1 | 1.1 |
| France | 2.6 | 0.9 | 0.7 | 1.3 |
| Italy | 3.9 | 0.7 | 0.6 | 1.1 |
| Spain | 4.6 | 2.4 | 1.6 | 1.9 |
| UK | 4 | 0.3 | 0.3 | 1.2 |
| China | 3 | 5.2 | 4.6 | 4.3 |
| South Africa | 2.3 | 0.6 | 1.1 | 1.6 |
| DM | 2.73 | 1.68 | 1.53 | 1.7 |
| EM | 3.06 | 3.94 | 4.15 | 4.15 |
| World | 3.1 | 3 | 2.8 | 3 |

Date sampled: 02/04/2024
Source: Bloomberg, Investec Investment Management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**Uncertainty has increased.** This year sees elections in over 50 countries, including the US, UK, and India. There is a non-negligible risk of further widespread government fiscal deterioration as incumbents spend to remain in power. While this should provide a boost to spending, the outlook for policy from next year in many countries, especially the US, is far from certain.  At this point, the betting market is pricing in a tight race between Biden and Trump. Elections across the globe are reason enough to expect a volatile year. However, there is a range of other reasons to expect a volatile year, not least of which is the continuing deterioration in commercial real estate prices in the US and Europe, and the continuing conflict in Ukraine and the Middle East.

**Inflation is set to slow, but to surprise on the upside.** The consensus view is that US inflation will average 2.7% this year, down from 4.1% last year. Inflation is proving stickier than the market expected and we expect that inflation will now surprise on the upside over the coming 12 months.

**There are risks to the interest rate trajectory.** The market is currently expecting three cuts of 0.25 percentage points (25bps) each over the year ahead but given better-than-expected growth and the risk that inflation continues to surprise on the upside, there is a material risk that the Fed cuts by less.

**Excess savings are being depleted.** We expect that at some point in the not-too-distant future US excess savings will be eroded – at a point when US monetary policy is likely to be tight and US fiscal policy will potentially be tight too.

**Fiscal pressures are building.** The surge in developed market yield curves over the past two years is affecting the fiscal position of their governments. The Fed and other developed market central banks will need to cut shortly or both fiscal and monetary conditions will be simultaneously tight. Given current debt levels, it is not clear that there is space for much fiscal support should there be a material slowdown in US GDP growth.

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**The Fed is set to ease up on quantitative tightening soon.** As per guidance in the minutes at the last Federal Open Markets Committee meeting, we expect that the Fed will start to ease up on quantitative tightening (balance sheet reduction) from the second half of this year. This should see improving liquidity in US fixed income – and potentially lower yields.

**Margins have been high – can they persist?** US corporate margins have persistently surprised on the upside over the past year, resulting in earnings proving to be more resilient than expected. New technology, such as the widespread use of AI, implies the possibility that margins remain high.

**Earnings forecasts are still optimistic.** Despite signs of an imminent slowdown in US and global growth, the consensus forecast is still for double-digit earnings growth this year. There is a material risk of sizeable downgrades over the coming months, even if margins remain higher than average.

**Chinese data readings are starting to turn.** Chinese exports are now up year-on-year, Chinese industrial production was up 7% year-to-date and year-on-year in February, and Chinese PMIs has recently surprised on the upside. It seems that Chinese data have started to turn. Given that inflation remains low, and will likely be below target for some time, further stimulus should not be ruled out.

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**The correlation between US equities and bonds is set to decline.** Research shows that periods of low inflation volatility are associated with lower equity/bond correlations. Inflation volatility has recently declined materially – suggesting a lower equity/bond correlation ahead.

**The US market is not cheap.** Despite the cloudy outlook, the market appears to be pricing an acceleration in earnings growth with a high level of conviction. We see more value in equities outside of the US, particularly in Europe and Japan.

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# South African market view and asset allocation – the election is key

**Election uncertainty.** Current polls suggest the ANC will fall below 50% of the total vote in the national elections at the end of May. Given that the average of the polls in 2019 was a fairly accurate forecast of the result, it seems likely that the ANC is going to get less than 50% and quite possibly less than 45% at the polls this time around. The reaction of the market to the ANC getting less than 45% will depend on who the coalition partners are – if a majority coalition can be built at all. Given the uncertainty around the election, we have chosen to not hold large off benchmark South African asset allocation positions. However, we aim to be nimble to take advantage of market dislocations should they occur.

**The fiscal target is at risk.** Treasury achieved a primary surplus last year and is penciling in primary surpluses for each of the next three years. It does not appear that the market is convinced. One reason for scepticism is a raft of literature that shows that coalition governments in emerging markets tend to be associated with larger deficits as coalition partners push for funding of their projects/mandates. The greater the number of coalition partners, the greater the deficit. We will revisit our expectations for the fiscus post elections but given current pricing, it does not appear that the market is giving Treasury much credit (despite mention of a proposed fiscal anchor to be decided by Parliament).

**The rand is particularly weak, for South African-specific reasons.** The average emerging market commodity exporting country has recently enjoyed material currency strength. The rand has been a notable exception. Based on our emerging market commodity exporter currency index, the rand would be trading close to R16.4 to the US dollar if this South African-specific risk was removed.

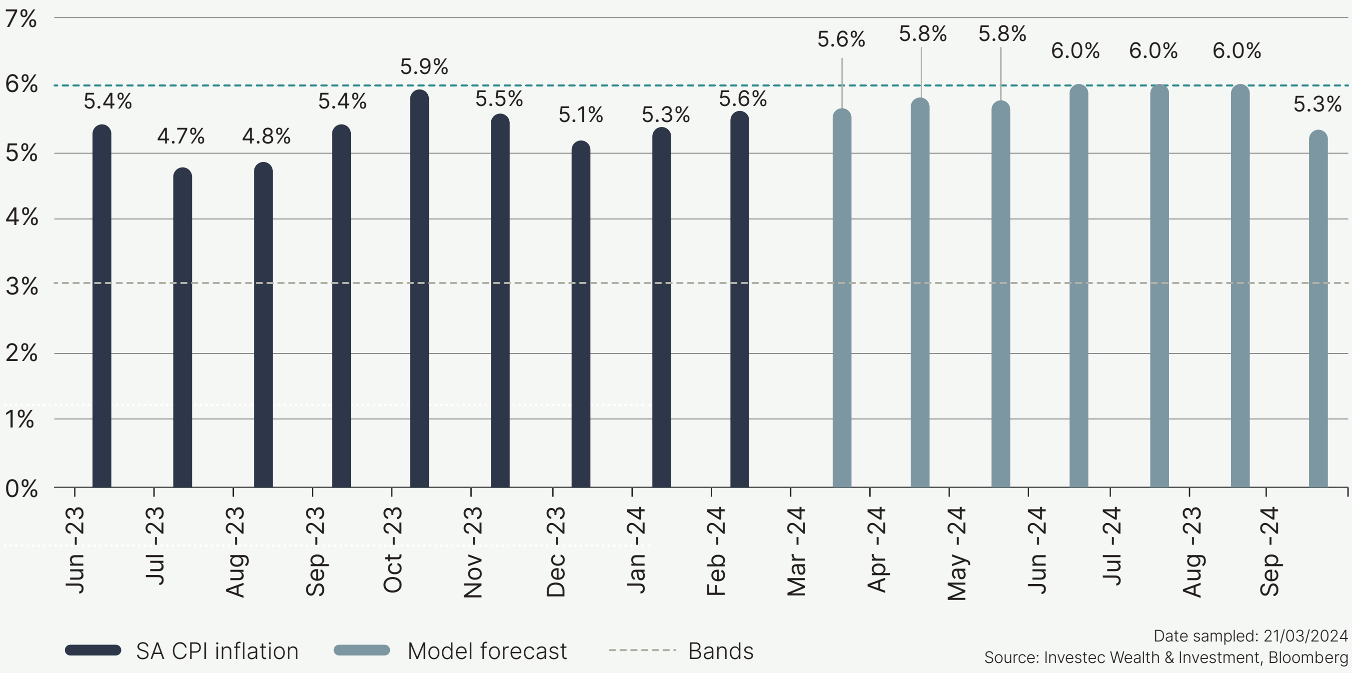
ZAR vs ZAR ex SA specific considerations


Date sampled: 31/03/2023
Source: Investec Wealth & Investment

Is the performance of the state-owned enterprises improving? We have created an index to measure the performance of state-owned enterprises (SOEs), considering electricity production, rail tonnage and the number of containers handled at the ports. Up until the beginning of last year, the index was in persistent decline, but it has recently turned. To the extent that SOE performance has held back the rand, the recent improvement, surprising as it may be, should translate into South African-specific rand strength. That's not however to say that the rand will go straight to R16.4. It will take some time for SOE performance to get to acceptable levels, even if there has been a turnaround. One should also bear in mind that other South African-specific factors are holding back the rand too. One further consideration is that our index captures operational efficiency at Eskom and Transnet but does not capture anything related to other SOEs, such as those linked to the provision of water.

South African inflation is elevated. Inflation has been within the target band since June 2023. However, the recent increase in Brent threatens to push inflation to the top end of the band by June, before tailing off after August.

### SA CPI inflation




Date sampled: 21/03/2024
Source: Investec Wealth & Investment, Bloomberg

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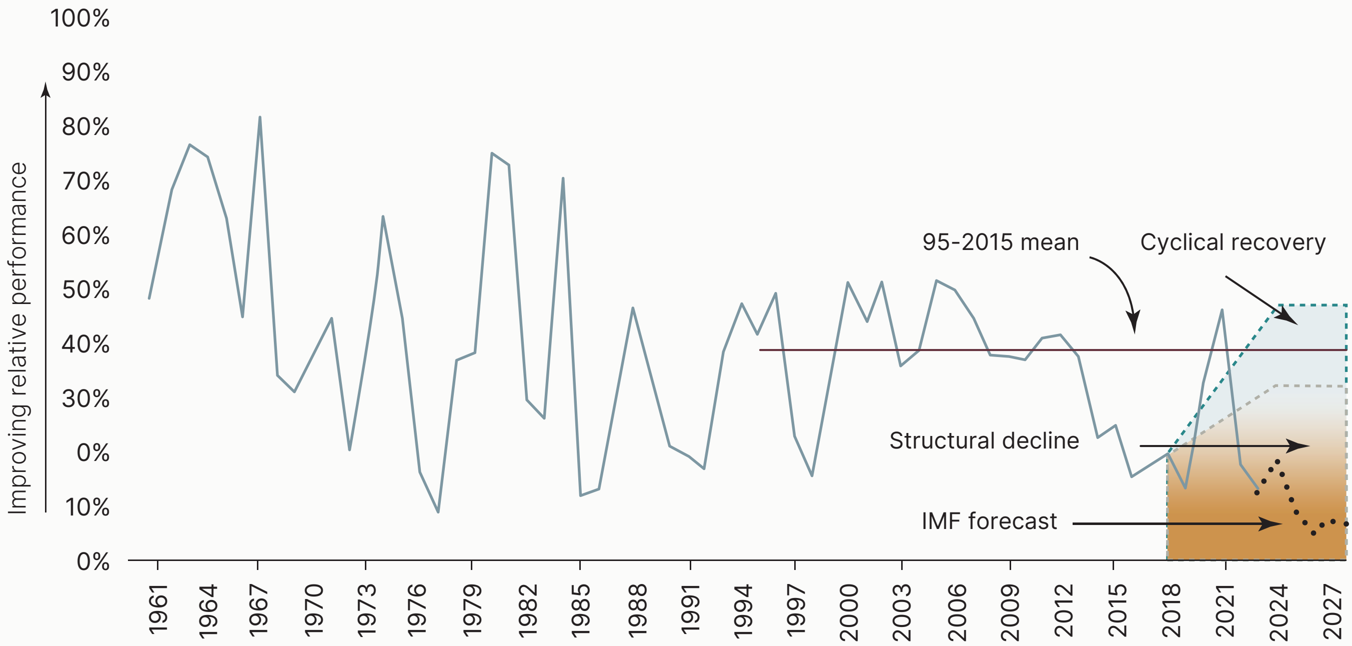
**The MPC is set to cut.** We expect 0.5 percentage points (50bps) of cuts from the Monetary Policy Committee (MPC) this year but for the cuts to only occur in the final quarter of the year.

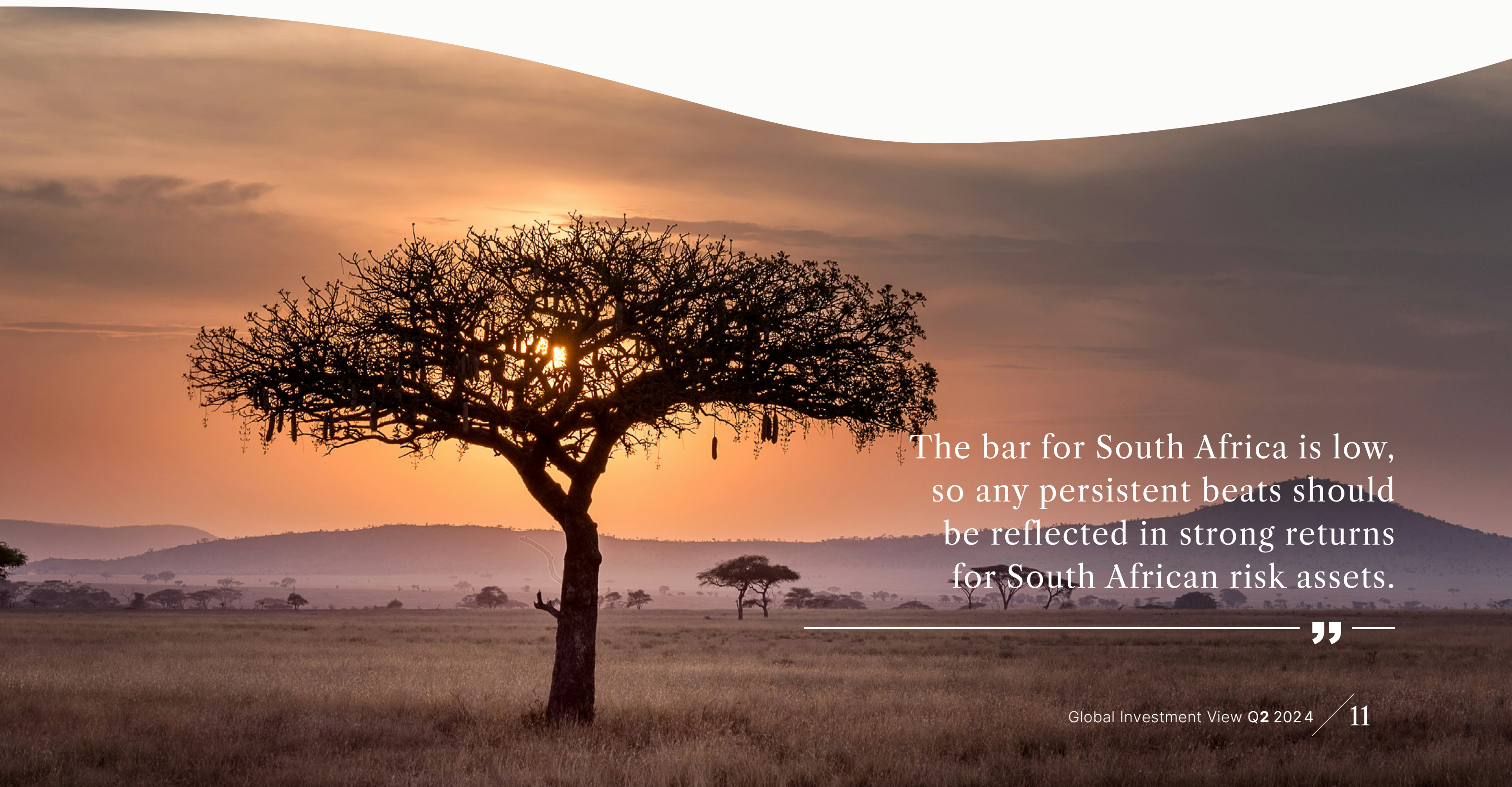
**Fixed income should outperform when rates are cut.** We have analysed the performance of fixed income, equities and gold at the start of rate-cutting cycles in the US since 1974 and in South Africa since 1998. In both cases, government bonds have regularly outperformed equities, gold and cash during the first 1.5 percentage points (150bps) of rate cuts.

**Expectations for South Africa are low.** The International Monetary Fund (IMF) expects GDP growth to be regularly in the bottom 15% of countries across the globe over the coming five years. Consensus, the Reserve Bank and Treasury all have GDP growth forecasts that are not materially different from the IMF. It is an unprecedented scenario. The expected structural decline in growth relative to global peers is reflected in South African equity valuations, the bond market and the currency market. In short, the bar for South Africa is low, so any persistent beats should be reflected in strong returns for South African risk assets.

## SA GDP rank-percent relative to the rest of the world




Date sampled:09/03/2023
Source: Investec Wealth & Investment, World Bank, IMF



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**Consumer incomes are holding up.** Employee tax data shows that formal sector income growth is running at around 8% year-on-year. The primary reason retail sales have been weak is higher costs for consumers – primarily interest payments and fuel costs. The net result is that we expect a material uptick in consumer spending as soon as fuel prices or rates are cut.

**Bonds are our preferred asset class.** South African government debt with maturity above five years is currently attracting a significant margin of safety. As the short rate comes down, we expect it will bring down the long bond yield too. However, even if government bond yields go up by one percentage point (100bps), which is not our expectation, by our calculation government bonds will give 5% over the year.

**Equities are cheap.** The South African equity market is unequivocally cheap. There is upside risk to earnings forecasts too, given the improving electricity situation.

**'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.

## *Valuation and asset allocation:*

### The SA risk scor e has also been maintained, at +0.5

Based on our estimates, South African asset classes screen as cheap both in an absolute sense and relative to peers, compared with global assets, which screen as expensive.

**Equities:** Screen cheap but weak global returns are likely to be a strong headwind. We favour SA Inc. Neutral.

**Bonds:** Screen cheap, but with the prospect of support from lower global bond yields. South African politics are likely to affect this asset class in particular. Overweight, looking to increase opportunistically.

**Cash:** We expect the Reserve Bank to cut rates by half a percentage point (50bps) by the end of 2024 the year.

**Property:** Sufficiently cheap to justify a neutral position.

**Gold:** Overweight given geopolitical risks.

The South African equity market is unequivocally cheap. There is upside risk to earnings forecasts too, given the improving electricity situation.

# 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 2024 | Q2 2024 | COMMENTS |
|---|---|---|---|
| Global Equity | - | - | GISG score negative. Global growth set to weaken with sizeable downside risk to earnings forecasts. US market does not offer sufffficent margin of safety. |
| Global Fixed Income | + | + | Global FI 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 | Q1 2024 | Q2 2024 | COMMENTS |
|---|---|---|---|
| SA Equity | **N** | **N** | SA equity market cheap. However global headwinds will still be strong for the forseeable future. |
| SA Fixed Income | + | + | Still margin of safety in SA debt in our view. The election this year implies will likely 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 an increase in interest rates. Utility costs passed on to tenants. |
| SA Preference Shares | **N** | **N** | Valuation for aggregate sector are near fair value. Opportunity in bank prefs though. |
| USD/ZAR (+ for ZAR strength) | + | + | USD/ZAR 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. Also a hedge against rising geopolitical risk. |

| SECTORAL/THEMATIC POSITIONING | Q1 2024 | Q2 2024 | COMMENTS |
|---|---|---|---|
| Global Plays | **N** | **N** | Neutral. Global outlook weak but global plays offer a hedge vs SA specific risk. |
| Commodities | **N** | **N** | Strong long term support from the global energy transition, neutral for now given global outlook. |
| 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 as electricity situation improves. Expected rate cuts helpful too. |
| Small/Mid cap | + | + | Valuations still attractive. |

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

# Contact details

Mauritius
6th Floor, Dias Pier Building
Le Caudan Waterfront, Caudan Port Louis, Mauritius
Telephone: +230 207 4200
Facsimile: +230 207 4003

Switzerland
Loewenstrasse 29
8001 Zurich Switzerland
Telephone: +41 44 226 10 90
Facsimile: +41 44 226 10 10

Johannesburg
PO Box 78055, Sandton, 2146
100 Grayston Drive, Sandown, Sandton
Telephone: +27 (0) 11 286 4500
Facsimile: +27 (0) 11 286 9595

Cape Town
PO Box 4059, Cape Town, 8000
14 Dock Road, Victoria and Alfred Waterfront, Cape Town
Telephone: +27 (0) 21 416 3000
Facsimile: +27 (0) 21 416 3598

Durban
PO Box 3912, Durban, 4000
5 Richefond Circle, Ridgeside Office Park, Umhlanga
Telephone: +27 (0) 31 575 4000
Facsimile: +27 (0) 865 00 99 01

London
30 Gresham Street London EC2V 7QP United Kingdom
Telephone: +44 (0) 20 7597 1234
Facsimile: +44 (0) 20 7597 1000

Pietermaritzburg
48 Bush Shrike Close, Victoria Country Club Estate,
Montrose, Pietermartzburg. 3201
Telephone: +27 (0) 33 264 5800
Facsimile: +27 (0) 33 342 1561

Gqeberha
Waterfront Business Park, Pommern Street
Humerail Gqeberha 6001
PO Box 13434 Humewood 6013
Telephone: +27 (0) 41 396 6700
Facsimile: +27 (0) 41 582 2536

Pretoria
PO Box 35209, Menlo Park, 0102
Cnr Atterbury & Klarinet Street Menlo Park, Pretoria
Telephone: +27 (0) 12 427 8300
Facsimile: +27 (0) 12 427 8310