Investec
Wealth & Investment

OUT OF THE ORDINARY

Global Investment View

Q3 2024 – Global inflation to decline, but slowly

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

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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).

FOREWORD: *South Africa's golden GNU*

Deep in the heart of South Africa, there exists a rare golden wildebeest, a golden GNU.

South Africa looks set to transition peacefully to a government of national unity (GNU) post the national election. Respect for the rule of law, the independence of the judiciary and the prioritisation of sound economic and fiscal policies prevailed, although some friction is likely in the ironing out of the details. This maturing of our democracy is heartening, a coming together. So it's worth taking a moment to celebrate the moments like this, as collectively we have been through so much turmoil.

The likely resulting increase in business confidence will provide a tail wind for South Africa and for investment in South Africa. Here, it's worth drawing a comparison between this new government and the wildebeest, an antelope also known as a gnu. A gnu is an antelope that is vulnerable to predators when it is alone, but when grazes in mixed herds, often with zebra, this creates strength for all. To continue the metaphor, we hope for more collaboration between all parties that are part of the GNU, as well as between government and business, to meet the needs of all South Africans, and to ensure its survival and growth.

In the energy and logistics sectors there has already been evidence of this, in the transition by many households and businesses to renewable energy sources like solar. We live in a golden country that's rich in sunshine. South Africa's renewable power generation capacity is about 10GW, of which nearly two-thirds is solar. Solar also accounts for the majority of the 10-15GW planned renewable capacity growth through 2030. Abundant and affordable energy matters for growth in South Africa. This growth has been and will remain reliant on successful collaboration between the public and private sectors.

Structural reform was already underway before the elections. New leadership and investment at Transnet have resulted in overall improvement at both ports and rail with both rail tonnage and containers handled recovering. We hope that the GNU will be a catalyst for further positive momentum.

We too see the benefit of collaboration. We believe that the depth of our relationship with you allows us to create better outcomes for your investments. Many of us, in addition to local investments, have investments offshore, and this remains prudent for the benefit of diversification. At the same time, our lives, our businesses, our families, and homes are here. We are deeply invested in South Africa on many levels.

While it is important to stay close in times of distress, it is equally important to celebrate the positives. In this case it's that rare wildebeest, a golden GNU, that exists in the heart of our country. We are hopeful that greater collaboration will create growth and prosperity for all South Africans. It is our time to shine in the sun.

Marc Romberg and Ali Nortier

Joint Heads of Wealth Management

The GISG kept its global risk budget score at -1 on a scale of +3 to -3, while the SA risk score has increased to 1.5 on a scale of -3 to +3

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 and global equity returns have continued to be strong, in part due to upward revisions to consensus GDP growth expectations. The current consensus forecast is that there will be no landing at all in the US and that US earnings growth over the coming year will be around 10%. The shift in narrative is partly attributable to continuing strength in the US labour market – and the expectation that this will persist further.

However, there are already signs that the US labour market is starting to weaken (jobs openings, the household survey and key leading surveys all point to weakness ahead and the unemployment rate has already started increasing). Inflation is proving to be sticky, implying that the Fed has limited room to cut rates quickly should the growth outlook deteriorate. In addition, fiscal pressures are building in the US. The government interest bill is around 3% of GDP, the highest in 60 years, and is set to continue to increase as debt rolls over. The net result is potential for both fiscal and monetary tightness in the US over the year ahead. In addition, the US market offers little margin of safety, in our view.

In contrast, the South African equity market screens as cheap. The performance of state-owned enterprises (SOEs) has improved materially and we expect that rate cuts are not far off. We have increased our allocation to South African equities to overweight and have a retained an overweight in South African fixed income.

Rationale:

Growth has been revised up. The strong rally in global equities over the past year has happened in part because of a material shift up in growth expectations. The current consensus forecast is for the US economy to grow by 2.4% this year, up 1.6% from the forecast a year ago. The EU GDP growth forecast for this year has been revised up by 0.2% from March. Post revisions, the consensus growth forecast seems somewhat optimistic, raising the prospect of GDP misses over the year ahead. US Q1 GDP growth already missed vs the initial expectation of 2.5%. Despite the sizeable miss, US growth forecasts for this year have not yet been revised down.

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

	2022	2023	2024	2025
USA	2.1	2.5	2.4	1.8
Japan	1.1	1.9	0.4	1.1
EU	3.45	0.5	0.7	1.4
Germany	1.9	-0.1	0.2	1.2
France	2.6	0.9	0.85	1.3
Italy	3.9	0.7	0.75	1.1
Spain	4.6	2.4	2.1	1.9
UK	4	0.3	0.6	1.2
China	3	5.2	4.9	4.5
South Africa	2.3	0.6	1.1	1.5
DM	2.73	1.68	1.66	1.73
EM	3.06	3.94	4.29	4.25
World	3.1	3	3	3

Date: 06/06/2024

Source: Bloomberg, Investec Investment Management

US labour market is still strong. At first glance, the US labour market remains in rude health. However, there are some signs that it may be weaker than it appears, a point made by Jerome Powell at the last Federal Open Markets Committee (FOMC) meeting. The household survey suggests a much weaker job growth than the nonfarm payrolls survey and it is possible that the nonfarm payrolls series is due a sizeable downward revision.

Increased uncertainty. The outlook for the year ahead is particularly opaque, in part due to the wide range of elections happening this year. The uncertainty attached to the US election alone is reason enough to be cautiously positioned. At the time of writing, the betting market was implying a close race between Biden and Trump.

Inflation is set to decline slowly. Rate hikes appear to have been successful in containing inflation but the last mile – getting inflation from 3% to 2% – will likely take some time. The current consensus forecast is for US inflation to average 3.2% this year, down from 4.1% last year. The average in 2025 is still above the Fed's target at 2.4%. The EU is set to have inflation in line with the central bank target sooner – set to average 2.1% in 2025.

Risks to the interest rate trajectory. The market is currently expecting three cuts over the year ahead of 25bps each, but the **Fed will likely be slow** in its reaction. The combination of strong growth and sticky inflation implies that the Fed is unlikely to be cutting aggressively – unless the US economy slows quickly. There is a material risk that US rates remain restrictive for some time, even as rates are cut across emerging markets and other developed markets.

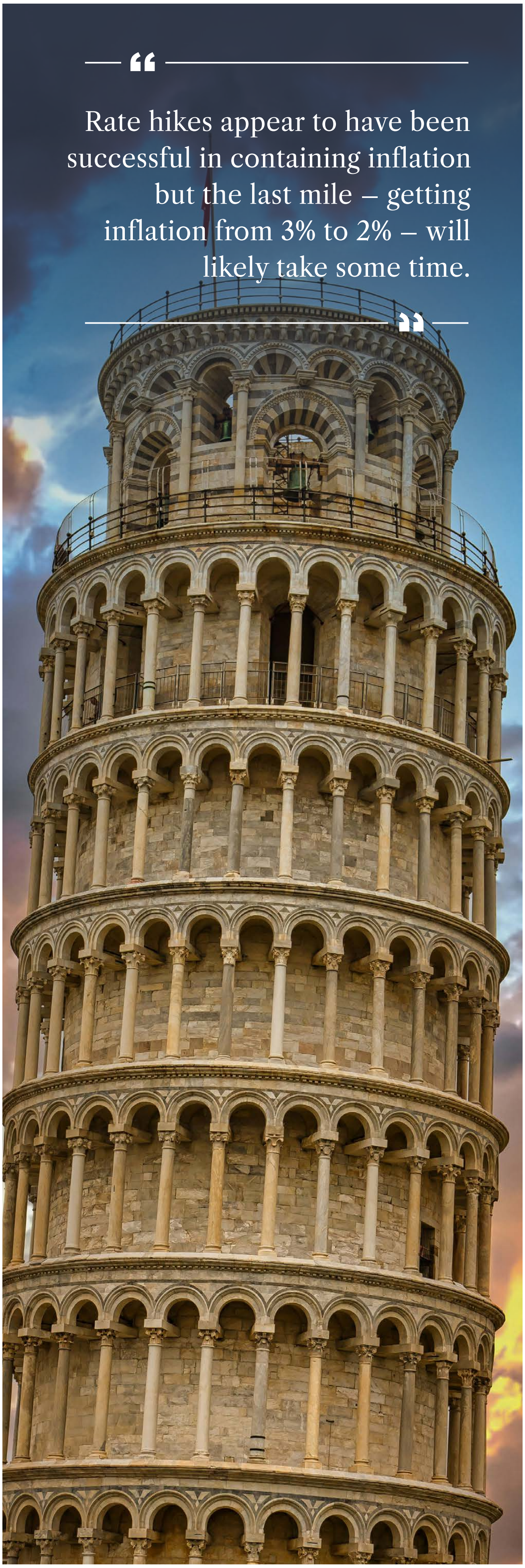
Fiscal pressures are building. The US government interest bill is close to 3% of GDP, the highest in at least 60 years. At some point in the near future, the interest bill will start crowding out other federal expenditure in the US.

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 tight, and the US fiscal policy is becoming a drag in the second half of 2024. The wealth effect implies some resilience in spending given the strength of the S&P 500, but we still expect spending to slow. Growth in spending will likely continue to be divergent across income groups in the US.

Fed to ease up on quantitative tightening. The Fed's slowing of the quantitative tightening programme of the last few years should provide liquidity to US fixed income markets – and take away some upward pressure on yields.

Commercial real estate prices to continue to decline. We expect that commercial real estate prices in both the US and Europe will continue to decline – but not enough to pose systemic risk.

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.



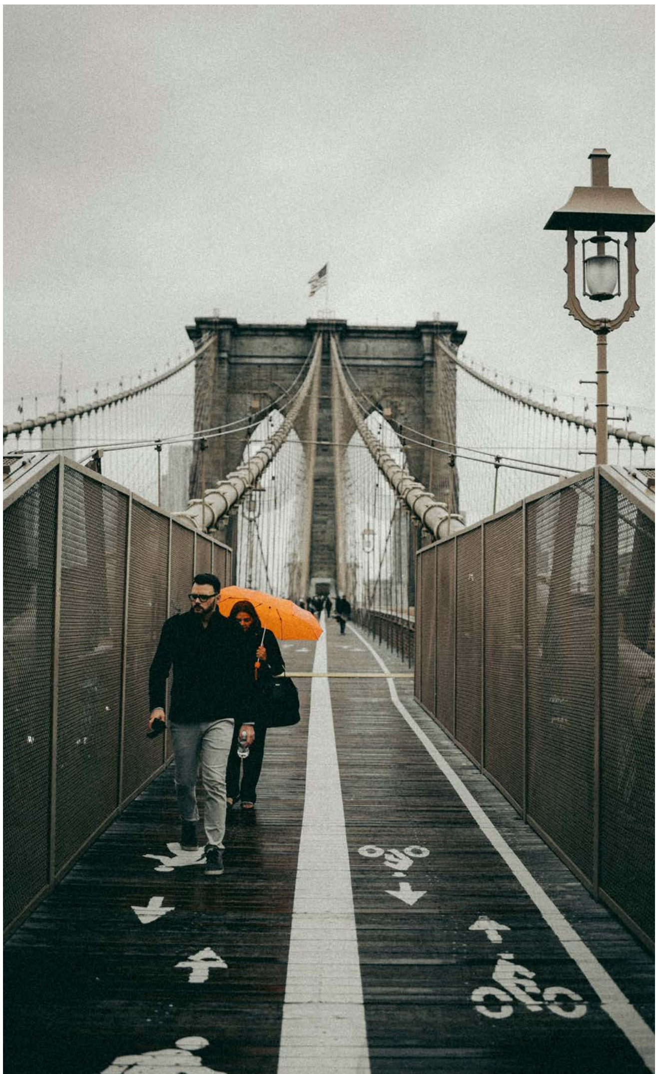
> "Rate hikes appear to have been successful in containing inflation but the last mile – getting inflation from 3% to 2% – will likely take some time."

GLOBAL INFLATION TO DECLINE, BUT SLOWLY

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 material risk of sizeable earnings downgrades over the coming months, even if margins remain higher than average.

Total social finance activity is a key leading indicator for the Chinese economy – there is a material risk that Chinese activity disappoints over the next nine months.

Risks in China. Total social finance releases have been well below expectation and the three-month average is down about 30% year-on-year. Total social finance activity is a key leading indicator for the Chinese economy – there is a material risk that Chinese activity disappoints over the next nine months.



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 no margin of safety in US equities at this point. The gap in valuation between the US and Europe, using our dividend-based model, is the highest in at least 20 years. Forward ratios (price/earnings, price/book and enterprise value to earnings before interest, tax, depreciation and amortization) all show the US to be trading at a near record premium relative to Europe. The forward price/earnings multiple of the S&P 500 is also near a record high relative to the that of the S&P 500 equal weighted index. There are opportunities outside of the US and even in the US outside of the mega caps, but the US market in aggregate, and as a result the global market, still screens as expensive.

Despite the cloudy outlook, the market appears to be pricing an acceleration in earnings growth with a high level of conviction.

South African market view and asset allocation – raising the local risk score to 1.5

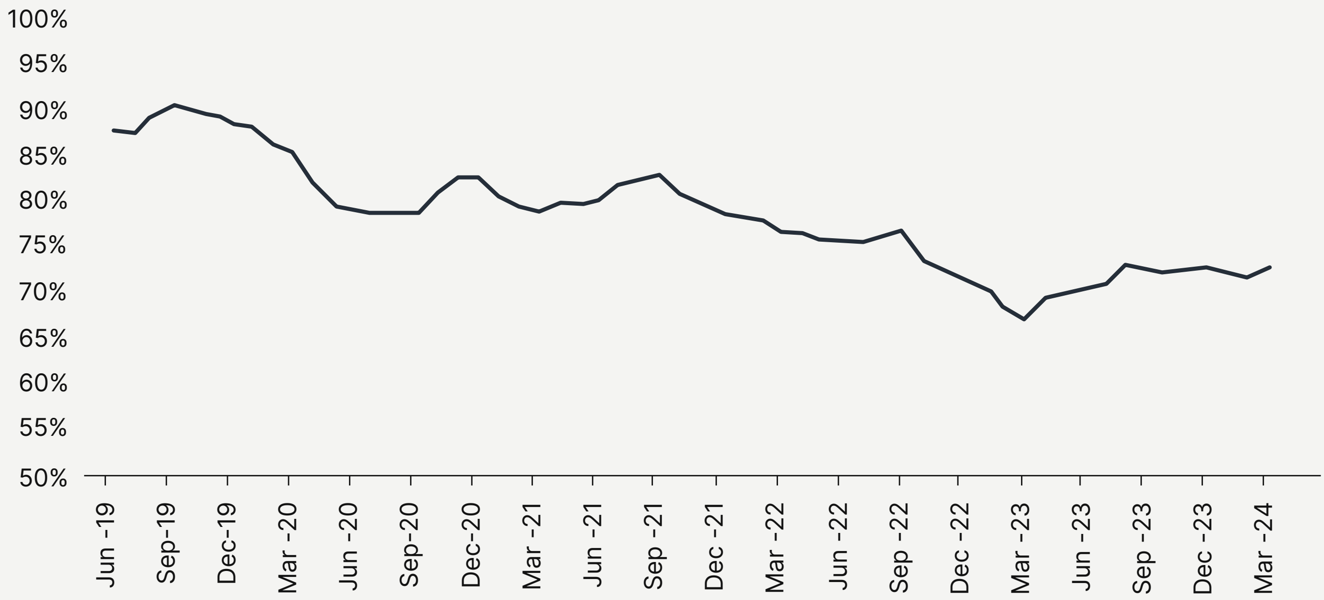
SA expectations are low. Growth expectations are low for South Africa. The International Monetary Fund expects GDP growth to be close to the bottom 10% of countries across the globe for each of the next five years. Its growth forecast of about 1% GDP growth is not materially different from Treasury, SA Reserve Bank (SARB) and consensus forecasts and we believe is reflected in South African risk assets.

Signs of structural improvement. Rail tonnage has increased over the past year, as has the number of containers handed at South African ports. In addition, Eskom's energy availability factor is at the highest level since 2021, with planned maintenance at a four-year high too. The improvement at South SOEs eases the binding constraint on GDP growth and suggests some upgrades to GDP growth and earnings are due.

The GNU provides further reason for optimism. The ANC can no longer rely on its legacy to get a majority in parliament. The net result is that it, and other parties, have a strong interest in delivering faster growth to get back into government. We have yet to see formal policies from the government of national unity (GNU) but our base case is that it will be largely market friendly.

Rate cuts are not too far off. Our inflation model suggests that inflation will get to around 4% in October, before drifting back up to 4.5% by year end. The SARB's forecast for inflation over the next few months is a bit higher and we expect they will be revised down at the next Monetary Policy Committee (MPC) meeting on 18 July. A rate cut in July is not out of the question, but even if it does not occur, we expect 50bps of cuts by year end. Rate cuts by other emerging markets and the European Central Bank have opened the door for rate cuts by the MPC before the Fed, if inflation gets close to the middle of the band.

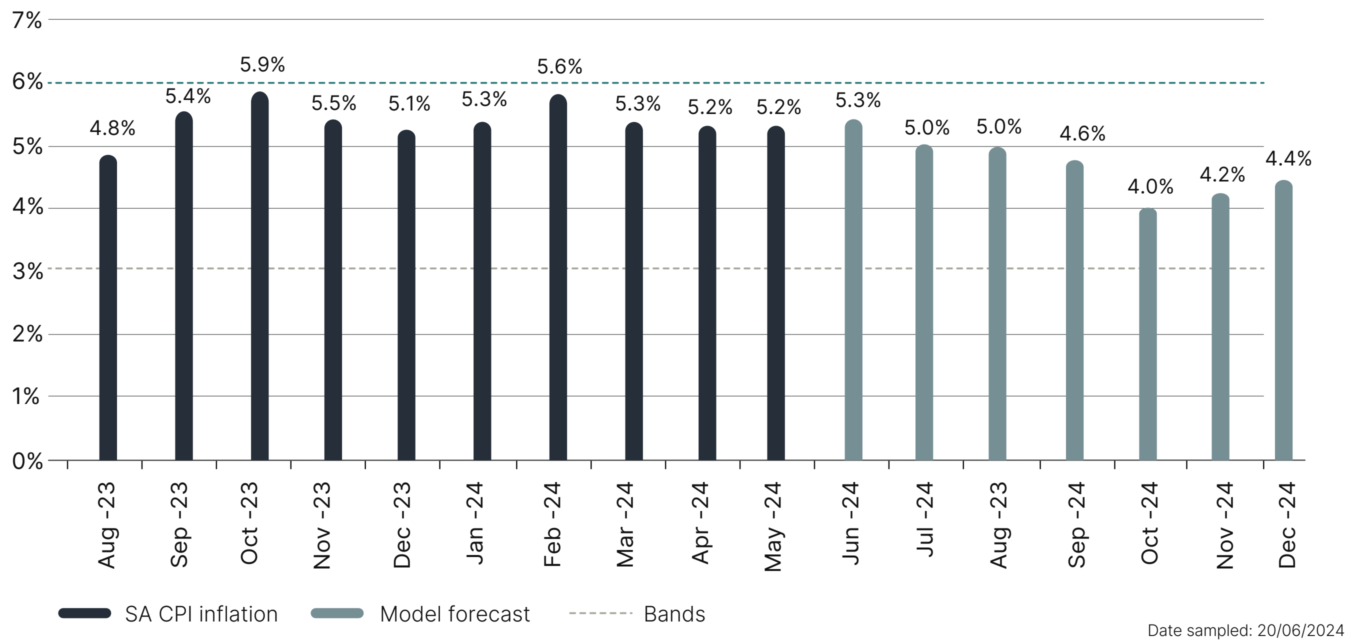
SA SOE Performance Index



Date sampled: 25/04/2024

Source: Investec Wealth & Investment, Stats SA, ESKOM, Transnet

SA CPI inflation



Date sampled: 20/06/2024

Source: Investec Wealth & Investment, Bloomberg

> Rate cuts by other emerging markets and the European Central Bank have opened the door for rate cuts by the MPC before the Fed, if inflation gets close to the middle of the band.

Business confidence is set to improve. The combination of improvements at SOEs, rate cuts and a renewed emphasis on accelerating growth by government should see business confidence pick up over the next few months. We expect that this in turn will lead to greater employment growth and investment.

SA consumer incomes are holding up. Employee tax data show that formal sector income growth in SA 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 spend as fuel prices decline and rates are cut.

SA is cheap. Despite the nascent signs of a turnaround, South African assets still trade at a material discount to global peers. SA equities, bonds and the rand all trade materially below our estimate of fair value.

SA equities appear attractive. The South African equity market is unequivocally cheap. There is upside to earnings forecasts too, given the improving electricity situation. We have increased our South African equity allocation to overweight while keeping South African bonds at overweight. We have funded the increased allocation by reducing cash.

'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 weaking economic backdrop. We expect that improving electricity availability and a potential reduction in rates will see a rerating, with upside risk to earnings forecasts. We have increased our 'SA Inc' allocation to double overweight, funding the overweight through a reduction in global consumer plays to underweight.

"We expect that improving electricity availability and a potential reduction in rates will see a rerating, with upside risk to earnings forecasts."

Fixed income outperforms when rates are cut. We have analysed the performance of fixed income, equity and gold at the start of rate cutting cycles in the US since 1974 and in South Africa since 1998. In both, government bonds have regularly outperformed equities, gold and cash during the first 150bps of rate cuts.

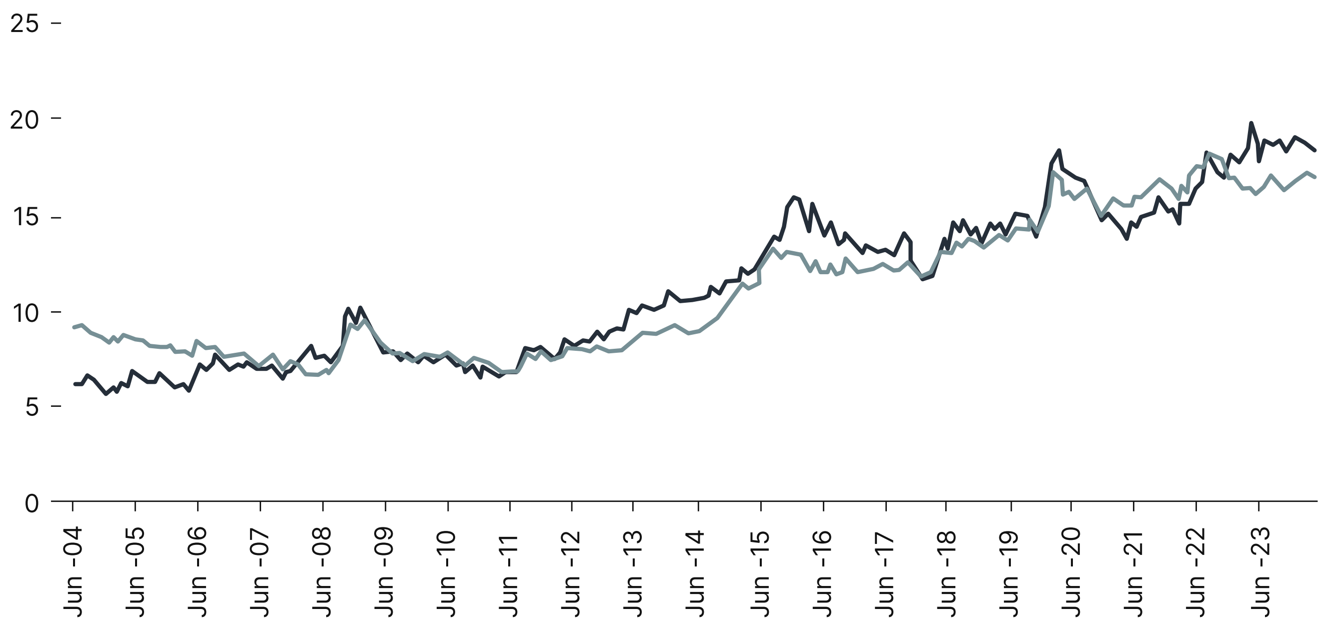
SA is underowned. The rally post-election shows how sensitive South African assets are to changes in sentiment. We expect this is in part attributable to local fund managers being underweight South Africa and foreign investors largely being underweight too. Should we continue to see good news out of South Africa, we expect to see material inflows into South African risk assets.

The rand is particularly weak for SA-specific reasons. Based on our emerging market commodity exporter currency index, the rand would be trading close to R16.9 to the US dollar if South African-specific risk were removed.

Fiscal target 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 skepticism is a raft of literature which 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.

Reconciliation with GISG. The GISG score is -1 on the back of recent strong global equity performance while the economic outlook has not appreciably changed and US equities are still expensive. The outlook for South Africa has materially improved and there is still a significant margin of safety in South African assets in our view, leading us to increase our South African risk score to 1.5

ZAR vs ZAR ex SA Specific risk



Date sampled: 14/06/2024
Source: Investec Wealth & Investment

One reason for skepticism is a raft of literature which shows that coalition governments in emerging markets tend to be associated with larger deficits as coalition partners push for funding of their projects/mandates.

GLOBAL INFLATION TO DECLINE, BUT SLOWLY

Valuation and asset allocation:

The SA risk score increased to +1.5 (from +0.5) Based on our estimates, South African asset classes screen as cheap both in an absolute sense and relative to peers. Global assets screen as expensive.

Equities: Screen cheap with structural tailwinds. SA Inc. favored sector. Overweight.

Bonds: Screen cheap with the prospect of support from lower global bond yields, lower local inflation and rates.

Cash: We expect the SARB to be cutting rates within six months.

Property: Sufficiently cheap to justify neutral position.

Gold: 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 CLASS	Q2 2024	Q3 2024	COMMENTS
Global Equity	-	-	GISG score negative. Global growth set to weaken with sizeable downside risk to earnings forecasts. US market does not offer sufficient 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 US equities. EM rate cuts should provide support.
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	Q2 2024	Q3 2024	COMMENTS
SA Equity	**N**	+	SA equity market cheap. In addition structural reform staring to bear fruit.
SA Fixed Income	+	+	SA inflation likely to be middle of the range or lower by year end. As a result we expect rate cuts are not too far off. Sizeable margin of safety in SA fixed income.
SA Cash	-	--	Rate cuts not too far off. We prefer to be exposed to SA risk and get insurance from offshore cash and fixed income.
SA Listed Property	**N**	**N**	Large discount to NAV. Hedged against increase in intertest rates. Utility costs passed on to tenants. However yield spread over fixed income not offering value. Prefer to be overweight fixed income.
SA Preference Shares	**N**	**N**	Valuation for aggregate sector 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	Q2 2024	Q3 2024	COMMENTS
Global Plays	**N**	-	Reduced to underweight on concerns about global market and simultaneous likelihood of SA specific rand strength.
Commodities	**N**	**N**	Strong long term support from global energy transition, neutral for now given global outlook.
Precious Metals	-	-	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. As the sector becomes more attractive we expect sizeable inflows from underweight foreign and local managers.
Small/Mid cap	+	+	Valuations still attractive.

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

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