Investec
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OUT OF THE ORDINARY

Global Investment View

Quarter 4, 2021

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Growth expected to be above trend, despite risks

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.

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COMMENTARY BY:

Chris Holdsworth

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, 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).

The Global Investment Strategy Group (GISG) maintains its neutral risk budget score (0 on a scale of +3 to -3)

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

Global risk assets (equities and high yield credit) continue to screen as expensive. In addition, inflation continues to surprise on the upside across the globe and growth is disappointing in the US and China in particular. However, global interest rates are still near record lows and we still expect to see above trend global GDP growth next year. We have therefore kept our risk score at 0, indicating a neutral allocation to risk assets. In our view, the key risk to markets is central bank balance sheet reduction, but we do not expect this to occur within the next 12 months.

South African equities and bonds continue to screen as cheap. In our view the market's expectations for commodity prices are too pessimistic, implying upside surprises for South African GDP and risk assets in general. The fiscal positioning is improving faster than expected, providing tailwinds for domestic bonds.

Key highlights of our positioning:

Covid-19 – economic / investment "case closed".

The latest global wave of Covid-19 infections peaked well below each of the previous two waves. In addition, the portion of infected individuals requiring hospitalisation has continued to decline as vaccines have been rolled out across the globe. We expect there will be further waves but that they will not be economically damaging. Early evidence suggests that vaccine efficacy declines over periods longer than six months, implying a requirement for booster shots but these will likely be shortly provided at scale, across developed markets at least.

Economies are tracking an encouraging path but the US has peaked.

The global economy is set to expand by 6% this year and is expected to grow by 4.5% next year. Having said that, data from both US and China have recently been disappointing and US growth expectations for this year have been markedly downgraded to 5.9% from 6.6% a few months ago.

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Valuations are stretched.

The S&P 500 is trading at 25% above our estimate of fair value (our model uses dividends and the prevailing 10-year bond yield as inputs). That would not be an issue if dividends were expected to grow by 25% over the next year but that is not the case.

Even if dividends were to grow by 15% over the next year, well above consensus, there is a material risk that discount rates will increase too. There are other signs of elevated prices for risk assets – for example, high-yield bond spreads are near 13-year lows.

CONSENSUS GDP FORECASTS	20	21	22	23
USA	-3.5	5.9	4.2	2.4
Japan	-5.1	2.4	2.55	1.2
EU	-6.8	4.9	4.3	2.2
Germany	-5.3	3.2	4.5	2
France	-8.3	6.05	4	2.2
Italy	-8.9	5.9	4.2	1.95
Spain	-11.4	6.1	5.7	2.75
UK	-10.1	6.8	5.4	2
China	2.3	8.4	5.6	5.5
South Africa	-7.2	4.21	2.3	2
DM	-4.92	5.22	4.02	2.26
EM	-0.62	6.55	5.22	4.83
World	-3.75	5.9	4.5	3.4

Date sampled: 14/09/2021
Source: Bloomberg, Investec Wealth & Investment

An uncertain inflation trajectory.

Supply chain disruptions have added another transitory element to inflation with the prospect of material rent increases to come following recent sizeable increases in house prices. The market at this point is pricing the recent increase in inflation to be transitory but there is little margin for error. We continue to expect that inflation will surprise on the upside but not enough to see the Fed hike in the near future.

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Risk of a quick taper.

There is a material chance of a six to nine-month taper followed by a rate hike from the Fed six months later but the market at this point seems to be taking a sanguine approach and there is a sizeable risk of a pullback in markets over the short term. However, if the Fed decides to become less accommodative, it will be for good reason – a strong economy – and therefore we would view any pullback as an opportunity to allocate cash to risky assets.

A slowdown in credit extension in China.

The slowdown in credit extension in China has led to a selloff in industrial commodities and disappointing data out of China. However, there is space for further monetary support in China and we may well see a further cut to the required reserve ratio or even a policy rate cut in the short term.

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Climate change effects could soon become apparent.

Over the next few months, we will get some guidance on fiscal responses to climate changes. The benefits could be immense – large scale infrastructure projects that will raise potential growth.

These will, however, come at a cost. There is a material chance of sizeable tax increases to come. It will take some time to figure out the full implication for markets.

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No clear preferred insurance policy.

The prospect of higher inflation with higher real yields makes it difficult to select a preferred insurance asset. Given the currently clouded outlook, a basket of insurance assets is probably more suitable than any one particular asset class.

A stock picker's market.

While the risk score of the committee is neutral, we expect that there will be a wide dispersion of stock and sector performance over the coming 12 to 18 months as growth and inflation slow but remain high by recent standards. The net result is that risk assets offer little margin of safety and tighter monetary policy is on the horizon. While the world continues to be awash with liquidity though, we think it is too early to take risk off the table.

If the Fed decides to become less accommodative, it will be for good reason – a strong economy – and therefore we would view any pullback as an opportunity to allocate cash to risky assets.

SA market view and asset allocation – commodity prices and cyclical recovery to support outlook

Overview

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

Key themes for the quarter:

We expect commodity prices to continue to surprise on the upside over the coming 12 months.

Aggregate commodity prices have recently reached record highs but the recent slowdown in China has called into question the short to medium-term outlook. The potential default of Chinese property developer Evergrande has further clouded the outlook for commodity prices. However, at this point it looks like there is limited evidence of contagion from the decline of Evergrande. While corporate sub-investment grade yields have spiked in China, investment-grade yields are still near record lows.

The potential default of Chinese property developer Evergrande has further clouded the outlook for commodity prices.

In addition, we have recently seen a cut in the required reserve ratio and we expect to see more stimulus from the Chinese government. This should provide some support for commodity prices but there is another strong tailwind behind commodity prices – climate change policies. The drive towards renewables is increasing demand for metals in an environment where mining companies are finding it more difficult to get access to cheap financing. We expect that the net result will be support for commodity prices over the short to medium term.

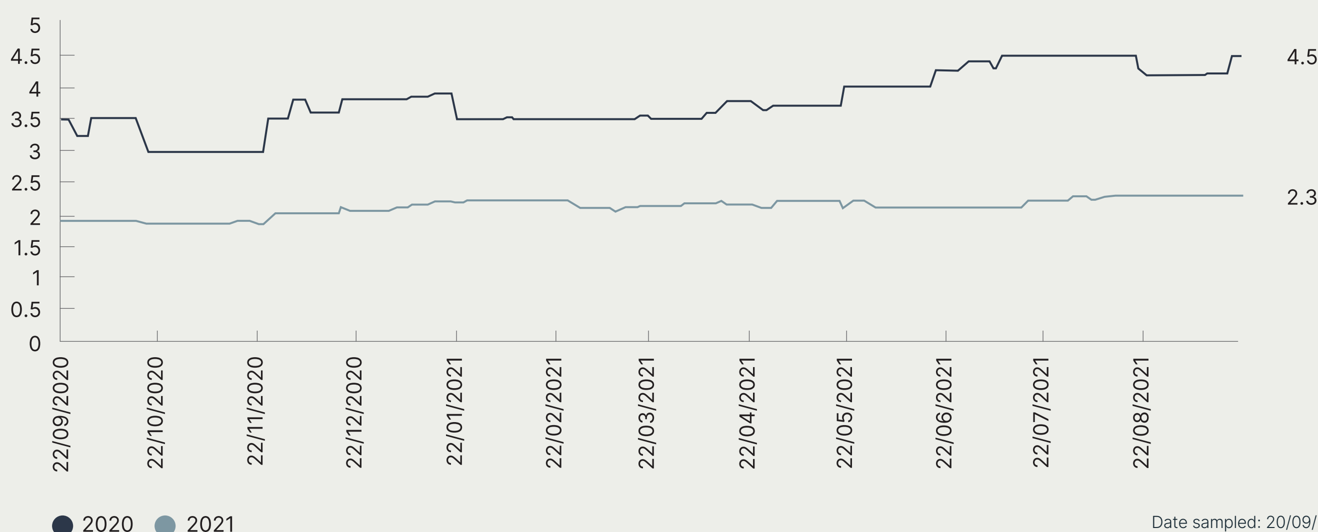
This however is not the market expectation based on what is priced into mining companies and analyst forecasts for trade balances for South Africa and other mineral exporting countries.

South Africa is still in a cyclical recovery.

The consensus forecast for GDP growth in 2021 has moved from 3% in October last year to 4.5% and still seems light by our estimate. The increase in growth expectations for this year has not been offset by a reduction in growth expectations for next year. Part of the surprise is directly attributable to mining but a significant portion is also attributable to retail activity surprising on the upside.

South African growth has continually surprised on the upside over the past 12 months.

Consensus GDP forecast



Date sampled: 20/09/2021

Source: Source: Investec Wealth & Investment, Bloomberg

Total wages in South Africa have already recovered to pre-Covid levels, with more to come.

Based on personal tax receipts, total wages in the formal sector had already recovered to 2019 levels by December last year and have since picked up. Business confidence in South Africa has also materially recovered and points to a forthcoming sizeable increase in employment over the coming 12 months.

We expect South African equities and bonds to outperform cash over the coming 12 months.

South African equities currently screen as fair value, while bonds screen as very cheap. The local equity market has scope for both a rerating and an increase in earnings growth while there is a material margin of safety in South African bonds, especially considering the improving fiscal position of the government.

Overview of the different asset classes:

Equities: Screen cheap. We remain overweight South Africa plays and resource counters.

Bonds: Screen cheap. The improving fiscal position should provide support for the local bond market.

Cash: Cash rates are currently low in both nominal and real terms. We prefer to allocate to risk through the domestic bond market.

Property: We prefer an increased exposure to South African yields through the government bond market.

Gold: Overweight as a hedge against South Africa-specific risks. In addition, disappointing global growth and higher than expected inflation should provide support.

Rand: We estimate the rand to currently be around fair value.

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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 2021	Q4 2021	COMMENTS
Offshore Equity	**N**	**N**	DM equities trading at highest premium to fair value since 2001 by our estimate. However global growth and earnings continue to surprise on the upside.
Offshore Fixed Income	--	--	DM bonds offer little value in our view. We see material upside risk to global bond yields.
Offshore Cash	**N**	+	Slight overweight as insurance policy.
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	Q3 2020	Q4 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. Short term inflation linked bonds look particularly attractive in our view.
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	-	-	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)	**N**	-	ZAR now trading around fair value.
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	Q3 2020	Q4 2021	COMMENTS
Global Plays	**N**	-	Underweight, preference for overweight in SA play and commodity stocks.
Commodities	+	+	Still cheap relative to commodity prices in our view.
Precious Metals	-	-	Precious metal producers offer a hedge against SA risk and leverage to a global recovery and weak ZAR.
SA Plays	++	++	SA consumer outlook is strongest in years, sector still cheap.
Small/Midcap	++	++	Valuations still attractive and investor appetite starting to increase.

By a number of measures, South African government bonds screen as cheap

By Chris Holdsworth

South African consumer inflation remains within the 3% to 6% band and the forecast, both from private sector economists and the Reserve Bank, is for the rate to drift down to 4% over the coming year. The output gap is still large, with some way to go before the country gets back to pre-covid levels of production.

Yet despite inflation being well contained and there being little sign that it will breach 6% anytime soon, the market is pricing in six (yes, six!) 25bp (0.25 percentage point) hikes over the coming 12 months. We think at most there will be two 25bp hikes over the coming 12 months, even though we also think inflation is likely to be a bit stickier than the market forecast. The above expectation of an aggressive Reserve Bank is at odds with the market expectation for the Fed, where rates are only priced to increase by 25bps by the end of next year.

What is more interesting however is that the Reserve Bank is then expected to hike further. The difference between three-year and three-month rates is 300bps (three percentage points), which is higher than any other developed or emerging market that we track. The market is therefore pricing in a peculiarly severe reaction to no material inflation risk.

It is not clear what is driving the concern expressed by the market. Perhaps there is a fear that the midpoint of the inflation target will be reduced, but whatever the reason, the net result is that the yield curve is very steep out to three years.

The market is therefore pricing in a peculiarly severe reaction to no material inflation risk.

An extraordinarily steep yield curve.

Out to 10 years, the slope is even more extraordinary. Assuming no term premium (the extra return you get for locking up your cash for a longer period), the market is pricing the repo rate to get to 15% in 10 years' time. In short, we have an extraordinarily steep yield curve by both historical standards and relative to peer markets.

The elevated long bond yield in South Africa is particularly strange when one considers the improving finances of the government – due largely to improving profitability for exporting companies. In addition, economic growth has been surprising on the upside – the consensus forecast for growth this year is 4.5%, up from 3% at the beginning of the year (we estimate that even 4.5% is too light).

The net result of improving government revenue and surprising growth has been an improvement to the debt-to-GDP trajectory. By our estimate, the current trajectory is not materially different from the forecast at the pre-Covid National Budget in February last year.

The medium-term budget policy statement on 4 November will hopefully confirm this.

All of this means that, in a world of still ultra-low yields, South African bonds screen as cheap – with significant macro tailwinds. Perhaps our bonds are cheap because South Africa is far from a safe haven, but based on our analysis there is still a material margin of safety in South African government debt.

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Global Investment Strategy Group

Chris Hills
CIO
United Kingdom

Professor Brian Kantor
Chief Economist & Strategist
Investec Wealth & Investment
South Africa

Philip Shaw
Chief Economist
Investec PLC

John Wyn-Evans
Head of Strategy
United Kingdom

Andrew Shard
Divisional Director /
International Investments
United Kingdom

Darren Ruane
Head of Fixed Income
United Kingdom

John Barkhan
Head of International Division
United Kingdom

Nik Kidd
Senior Investment Director
United Kingdom

Oliver Battersby
Senior Investment Director
United Kingdom

Paul Deuchar
Head of Portfolio Management
SA South Africa

Ryan Friedman
Portfolio Manager &
Head of Multimanager
South Africa

Paul Mckeaveney
Portfolio Manager & Chairman SA
Asset Allocation Committee
South Africa

Neil Urmson
Wealth Manager
South Africa

Annelise Peers
CIO
Switzerland

Chris Holdsworth
Chief Investment Strategist
South Africa

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