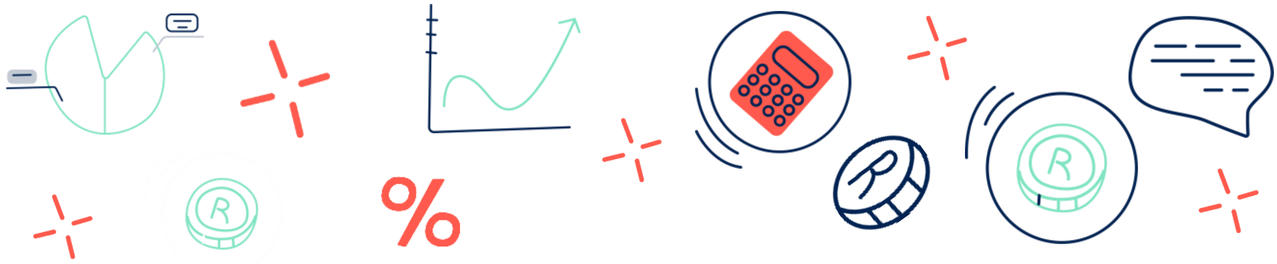
Truffle Asset Management

Economic Commentary
March 2024



The strength of the US economy continues to propel investor optimism even though interest rates appear set to stay higher for longer. China's annual parliamentary meeting did little to change sentiment as stimulus measures remain limited, while South African markets struggled amidst pre-election uncertainty. Fortunately, a commodities rally in March supported quarterly market performance.

Opportunities amidst relentless US strength

Recent data shows that US strength continues to reward wage earners and any indications of the economy losing resilience appear to have dissipated, driving market expectations further towards a soft (or even no) landing. Unemployment remains low and payrolls continue to exceed expectation while the PMI index has crossed the 50 threshold into expansionary territory at 50.3.

As economic strength persists, the downward inflation trajectory has come into question with some months in the quarter registering metrics above expectation. The risk remains that inflation settles above expectations of 2% or requires more aggressive monetary policy than the three rate cuts this year priced by the market.

Although long term rates have risen, the US equity market surged over the quarter as corporate earnings have proved resilient, resulting in a compressed Equity Risk Premium (ERP) of circa 1%. US market valuations remain elevated, and the likelihood that reasonable returns can be earned by the mega-caps seems low especially if one considers how lofty long-term earnings expectations are for this group of shares. However, with the manufacturing cycle bottoming out, and data still reflecting a strong economy, a pullback may not be imminent.

Outside of US equity, other markets or specific sectors are offering compelling value with a reasonable earnings outlook, notably:

- Certain Asian countries have cheaper exposure to the AI opportunity and would benefit from a turn in the manufacturing cycle.
- European equity markets offer some deep value opportunities, notably companies within the Financials and Energy sectors which are engaged in share buy backs.
- Fixed income markets are more fairly priced relative to 2023. Shorted dated US treasuries offer a 4-5% yield, which can be further enhanced by investing in credit.
- Short dated European credit also presents a real return opportunity.

Overall, Europe should benefit from an upturn in the manufacturing cycle and lower energy costs; however, this will need to be balanced against higher interest costs on sizable amounts of debt that are maturing this year.

China's Year of the Dragon

As China begins a new year, the lack of meaningful fiscal stimulus continues to hamper growth prospects while rebalancing China's economy from investment to consumption-led will be difficult even with stimulus. Like the US, the PMI has moved into expansionary territory, but employment gains are weak, and prices remain in deflation.
China's National People's Congress, an annual significant political event, held in March illustrated the country's ambition to compete with the US on technology; however, the lack of further stimulus measures disappointed markets with growth likely to slow more going forward as a result.

Chinese valuations are low relative to most regions. However, global investor appetite (and the prices investors are willing to pay) for Chinese assets remains uncertain given the weak growth prospects as well as the challenging regulatory and geopolitical outlook.
This risk should be balanced against the availability of well-run businesses that can produce decent cash flows. We therefore maintain a modest exposure to Chinese assets.

Glittering gold

Most commodities rallied strongly over March lifting commodity performance for the quarter. Copper is benefiting from an improved outlook for global manufacturing which has slumped over the last year. Lower supply guidance from major miners is also resulting in a continuation of expected deficits. Iron ore on the other hand, has underperformed due to reduced steel production and strong supply.

Gold has historically shown an inverse directional relationship with USD real interest rates however, despite range bound real rates, the shiny metal has reached record highs. This is potentially due to higher demand from Central Banks who are wary of geopolitical tensions and fear that the confiscation of USD reserves is becoming a meaningful risk. It is also possible, although less likely, that rising tail risk of inflation induced by US debt is becoming a concern. We currently maintain a position in gold given ongoing heightened geopolitical risk and elevated real rates.

Oil prices surged, mostly off the back of numerous supply issues, with US crude futures reaching $85 per barrel for the first time since October. Houthi attacks in the Red Sea resulted in delivery delays to European consumers while Mexico is curtailing crude exports to increase domestic refining; the likelihood of sanctions against Venezuela is also increasing. Amidst growing oil demand from China as manufacturing increases, numerous OPEC+ supply cuts have also driven prices up.

South Africa gaining energy

Uncertainty over election outcomes continues to drive weak appetite for risk assets and local investors remain uncertain amidst economic inertia. Some polls are indicating a lower result for the ANC than tabled earlier this year, and while changes are still possible just two months from election date, a coalition government remains likely.

Positively, updates from Rudi Dicks, Head of the Project Management Office within the Presidency are signalling much needed improvements to local infrastructure.

There is optimism that the worst of the energy crisis is behind us due to a combination of increased private sector power generation and better performance from Eskom's coal fleet. While loadshedding remains an issue, the average stage of loadshedding in the first two months of 2024 was 1.8, much better than the average of stage 3.8 that was recorded in the

first two months of 2023. Eskom estimates that the rooftop solar capacity installed in the country was up to 5.4GW by the end January, with 2.4GW installed over the past year, resulting in YTD demand for Eskom power being down 7.1% vs the same period last year. Demand is down just over 9% from the equivalent period in 2019. Given the better performance in energy generation the focus has moved to transmission. Around 14 000km's of new grid capacity is required. Funding for this additional capacity will need to come from third parties who require generation assets to be split from the transmission and distribution assets. A split of this nature is dependent on debtholder approval which was recently obtained.

Poor logistics has also weighed heavily on the local economy - the University of Stellenbosch estimated that Transnet's inability to rail sufficient volumes of mostly coal and iron ore to ports could have cost the economy as much as R411bn in FY22 and a further R353bn in FY23. Economic reform is clearly highly dependent on a Transnet turnaround and the appointment of Michelle Phillips to a permanent position as CEO is a crucial step in their restructuring strategy.

Accumulating a maintenance backlog of an estimated R200bn whilst servicing expensive debt has added significant urgency to the implementation of a credible restructuring plan. Partnering with private sector companies to operate trains independently on the state-owned rail network across SA is therefore positive with the recent Freight Logistics Roadmap and the release of Transnet's draft network statement important steps in the process. If all goes well, trains run by private operators could be operational in the second half of the year provided tariffs encourage the transport of tonnage to move away from trucks and onto rail. While Transnet progresses in the right direction, it is also pleasing to note that port operations have improved from a low point in 2023 and various initiatives support further improvements.

South Africa's economy grew 1.2% year on year to 31 December 2023, slightly ahead of market expectations. However short-term economic headwinds remain unchanged with tight monetary policy likely to be in place until after the election and / or when the US Fed starts cutting rates. While local valuations remain cheap, with significant long-term uncertainty it remains important to focus on companies offering strong cashflow and dividend yields.

Outlook

Overall global markets have experienced a good start to 2024 and while continued economic resilience with rate cuts implemented later in the year could sustain market strength, US equity valuations are elevated and at risk of falling. Within our global portfolios, we remain underweight the US equity market in our offshore positions but have increased pour exposure to European stock markets which are trading in fair value territory. We maintain an exposure to Japan given reasonable valuations and constructive changes to the Japanese economy.

Locally, we continue to adopt a defensive stance ahead of elections and given ongoing economic uncertainty. We prefer companies with exposure to offshore markets and stay focused on companies trading on generous valuations and with good dividend yields. In the short-term SA could benefit from a cyclical market recovery as global manufacturing strengthens and thus supports commodity prices. By next quarter we should have better visibility of the longer-term impact of election outcomes.

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Morningstar Awards were awarded to Truffle Asset Management (Pty) Ltd on 23 March 2022, 22 March 2023, and on 14 March 2024. Details available on request.

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