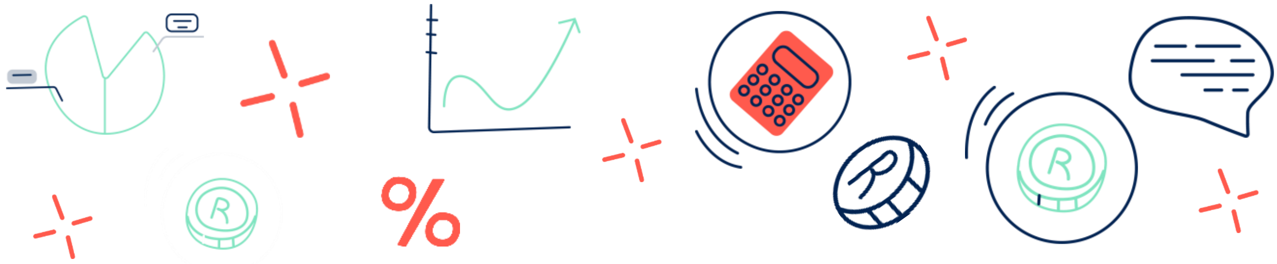

Equity markets make a comeback

Global equity markets (except for China) made a comeback in the fourth quarter, spurred by fresh optimism of imminent US rate cuts following a two-year hiking cycle. Once again, the broader US economy failed to succumb to pressure from higher rates while China continued to disappoint.

South Africa's market performance remains sensitive to global and local economic data and news flow as investors seek positive outcomes for deep idiosyncratic challenges.

US headwinds building

The US is yet to slow down. Inflation continued to fall with buoyant but lower wage growth while employment and GDP growth stayed resilient. Pandemic savings, fiscal spending, fixed mortgages and the wealth effect benefit from higher property prices and equity markets more than offset the impact of higher rates.

The factors driving economic resilience in 2023, are likely to become headwinds into 2024. Consumers' excess savings for middle to lower income groups are now largely depleted and credit card delinquencies and defaults are accelerating. The lagged effect of a tight monetary policy may well be more extreme in the US in 2024 given the long term of their mortgage debt. US monetary policy is tight with one-year real rates at 2.8% relative to median rates of the last decade that were only marginally positive. Unless rates go back to zero real, even lower rates than today will still be a headwind as long-term debt reprices.

High levels of government spending growth in 2023 will likely detract from US GDP growth going forward. Falling job openings increases the risk of the unemployment rate rising from current low levels which will be negative for consumption.

The bond market is pricing 1.3% of rate cuts in 2024 and reaching a rate of 3.3% by the end of 2025. This implies the market is pricing in a soft landing and inflation stabilising back to a long-term trend in the low 2% range. US equity markets appear to be pricing in an optimistic outlook with Price Earnings (PE) ratios of more than 19.5 and punchy EPS growth expectations of 10% p.a. over the next 2 years.

US expected real returns are about 3.3% vs real bond returns of 1.8% meaning a paltry 1.5% equity risk premium. The S&P500 may have risen 25% in 2023 however the top 10 stocks accounted for 75% of this return and now comprise 35% of the index representing significant concentration risk. The equal weighted S&P500 is more reasonably priced but also offers a low return of 4.3% real relative to 1.8% from US bonds.

The US Fed estimates that 50% of real corporate profit growth between 1984 and 2020 was from a secular fall in interest rates and corporate tax cuts. This will not be repeated. A further long-term concern for markets is the significant level of future bond issuance which places downward pressure on yields.

China's prospects uncertain

China stood out as the underperforming economy and market in 2023 and continues to face significant structural challenges. Geopolitics is weighing heavily, and inbound foreign direct investment is at multi-decade lows. The Chinese consumer remains depressed and saved more in the first 10 months of 2023, despite the economy opening.

Overall Fixed Asset Investment in China grew 2.5% year on year, helped by manufacturing and infrastructure. However, the key driver of metal demand historically has been China's growth in property investment which declined 9%.

The Chinese Economic Work Conference in December recommitted to the "industrial economy". There was emphasis on quality of growth and recognition that the property sector is a major economic and financial risk. Again, they reiterated that housing is for living and not speculation. Regulatory policy seemed to be easing although not consistently, as evidenced by a further gaming regulatory crackdown in December. Furthermore, a reduction of available economic data and concerns regarding the accuracy of GDP data adds additional risk to the Chinese investment thesis.

While the risks to investing in China remain high, Japanese equity is well positioned to benefit from structural and cyclical factors arising in Japan over 2023. Business friendly stock market reforms are supportive of unlocking value. Companies could face delisting if they do not improve capital allocation to boost valuations and returns. Unwinding of cross holdings should also be a positive catalyst. Returns on capital already appear to be improving and valuations are reasonable with PE's trading in line with long run history.

Japanese wages reached a 26-year high in 2023 and are expected to remain above 2% over 2024. The Bank of Japan will maintain accommodative monetary policy unless wages exceed 3%. Against a backdrop of economic strength, the Japanese yen is one of the most undervalued currencies on a purchasing power of parity basis.

South Africa's elections pivotal for growth

By the fourth quarter of 2023, South Africa's idiosyncratic challenges including load-shedding had been well established with the focus shifting from short term crisis management to long term reform. The local equity market rallied in Q4 supported by global sentiment and prospects of lower interest rates however local economic challenges persist.

The outcome of South Africa's 2024 elections, likely to be held in May, will be critical. Voter turnout and the youth vote are two key unknowns and while polls are notoriously noisy, at this stage there is alignment around an ANC outcome of between 43% and 46%. Many changes are possible before election day, but it appears likely that the result will be some form of coalition government.

SA's 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. A reduction and stabilisation of load-shedding is beneficial for business outlook however other than tourism strength over December, consumer data remains subdued and logistics challenges weigh heavily on economic growth prospects. Transnet's turnaround efforts are positive although complex and will take time following years of poor management.

Low economic growth continues to place pressure on fiscal consolidation, and SA will need to reduce SOE debt, or grow GDP to reach a healthier sovereign balance sheet.

Low valuations across both SA's equity and bond markets continue to partly take account of the above-mentioned macroeconomic risks. Credit spreads on SA bonds reduced over the quarter to trade in line with the median of the last 5 years. Any further strength will likely require a decline in global rates.

Summary and outlook

As interest rates peak globally, markets are optimistic around the speed and magnitude of a rate cutting cycle in 2024. However, central banks are likely to be cautious in their approach, avoiding any chance of inflation spiking once again.

Locally, we remain exposed to Financials where we still think absolute valuations are compelling. The dividend yield of our aggregate holding is circa 8%. Domestic small and mid-cap industrials are also reflecting compelling value with a few counters trading on PE multiples of 5-6 including Motus and Supergroup. Several high quality offshore exposed ALSI listed companies are also trading on generous valuations including Bidcorp and Anheuser Busch.

We remain underweight the US equity market in our offshore positions and prefer to hold short dated fixed income given the stretched US equity market valuations. European stock markets are trading in fair value territory while we have increased our exposure to Japan given reasonable valuations and constructive changes to the Japanese economy.

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

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