

AUTHOR: SAUL MILLER & NICOLE AGAR, PORTFOLIO MANAGERS

Higher yields, shifting risks

Higher US yields, stubborn oil prices and a still-expensive dollar shaped the quarter, and the outlook remains uncertain. Locally, South Africa's higher starting yields helped cushion the sell-off while the macro-economic backdrop retains supportive features amidst structural low growth.



US: Yields closer to fair value

US long bond yields breached 20-year highs this quarter, driven by several factors:

- High oil prices which have required tighter monetary policy to offset the inflationary pressure.
- A still-buoyant economy, with recent consumption growth well above expectations.
- Rising concern around the unsustainably high fiscal deficit. Market participants disagree most about this last factor. Sceptics argue that if deficits were driving yields, the dollar should also have weakened. A less convincing argument is that the deficit outlook has not worsened over the past year.

We believe that much of the upward move in yields is now behind us. The short end of the curve is pricing interest rates to rise to 5%, which seems restrictive even if inflation stays elevated at 3% for a year. Ten-year yields, meanwhile, now sit above sustainable nominal GDP growth. That said, until the economy slows or fuel prices fall, yields will likely remain elevated. However, we believe at least one of these is likely to occur over the next year, which should provide some relief.

Fiscal concerns will nonetheless remain unless potential growth shifts significantly and structurally higher through an AI-driven acceleration in productivity. Aggressive tax reform could address the deficit, but this is only likely after the next election. Over the medium term, we expect yields to remain well above the levels of the last decade, when deleveraging and disinflation produced low real rates. Higher yields are already weighing on the broader US market. The equal-weighted S&P 500 has declined despite some positive earnings upgrades.



US dollar: Still overvalued

On a Real Effective Exchange rate basis, the US dollar remains in expensive territory. With almost 1% of interest rate hikes already priced into the market, rate expectations could now become a headwind for the dollar. Central banks will probably keep diversifying away from dollar holdings which also adds medium-term pressure.



A major break in the dollar would, however, likely require large-scale underperformance in US equities. Although risks to hyperscalers capex remain, the short-term outlook remains stable. The financing of the AI capex cycle has become increasingly circular, but we do not believe it is about to collapse. Over the next two years the frontier large language models are funded, the hyperscalers can meet their obligations from cash flow and orderly issuance, and Nvidia's guarantees are underwritten by strong cash generation. However, vulnerabilities remain. As noted last quarter, value will ultimately need to migrate up the value chain. In the long term the large language models must establish a path to self-funding before an economically sustainable ecosystem can emerge.



Commodities: Oil uncertainty persists

Oil price uncertainty remains high in the short-term. Both crude oil prices and crack spreads remain elevated. Real diesel prices are 42% above their five-year median in the US and over 60% higher for Europe.

Crude volumes through the Strait are close to pre-war levels despite the absence of a deal. This is happening at great expense to the US military, which is providing the escort service - an arrangement that cannot be sustained over the medium-term. The flow of refined product (petrol, diesel, jet fuel) through the Strait remains severely restricted whilst the damage to Russian refineries from the Ukraine War has pushed crack spreads higher still.

A resolution seems improbable for now as the two sides' expectations are poles apart. Iran will likely need to feel more economic pain, and the US more political pressure, before a settlement is found. If a deal is to be reached, it will probably come after the US midterm election. Until then, Iran will likely attempt to keep oil prices uncomfortably high for consumers (and therefore voters).

New supply routes for oil and increased refining capacity will eventually reduce stretched crude oil prices and crack spreads, although the timing of this is uncertain. We remain negative on the oil price over the medium term as we see growing demand for renewables to continue to exert downward price pressure. Electric Vehicle penetration continues to rise (even 40% of Chinese trucks sales are now electric), and Europe is expected to increase the share of both renewables and nuclear in its energy generation. Lower fuel prices should in turn reduce bond yields and interest rate hike expectations, which should weaken the dollar.

The long-term narrative of central bank diversification away from the dollar should continue to underpin gold prices, although gold remains elevated in real terms. In the shorter-term, a weaker dollar and stable, if elevated, long-term real rates should provide further support.





South Africa: Growth outlook remains low, but the fiscal trajectory is positive

South African bonds sold off in line with developed market bonds this quarter. Despite the weakness, SA bonds outperformed their US counterparts, which shows the benefit of entering periods of volatility with elevated starting yields.

The domestic macro-economic backdrop also retains several supportive features; most notably, fiscal consolidation remains intact despite a weak growth environment. While South Africa's structural growth rate remains low, the debt trajectory has stabilised and the country continues to generate a budget surplus before interest costs. This provides an important counterweight to the cyclical weakness, and contrasts with the widening fiscal deficits evident across several developed markets.

Should the current oil-price shock and associated volatility subside, we expect headline inflation to resume its downward trend towards the SARB's target. This would allow the monetary policy backdrop to become more supportive of economic growth.



Positioning our funds

In this environment, we continue to favour positioning that is not overly reliant on any single outcome. We maintain reasonable exposures toward financials which still offer 6% plus dividend yields and high single digit earnings growth. While the local retail sector has significantly underperformed over the last year and valuations are optically cheap, we remain concerned about the ability of these companies to grow their earnings in the face of some of the structural challenges.

We continue to hold large positions in offshore exposed shares given their compelling valuations and high earnings quality. Within the resources complex we remain positive on the long-term prospects for copper, and we continue to prefer PGM stocks over the gold stocks within precious metals as we think PGM miners are more geared to higher prices than the gold miners.



AUTHOR

Nicole Agar, (CA) SA | Portfolio Manager & Analyst

Nicole Agar is a senior portfolio manager at Truffle Asset Management with over 25 years of investment experience. She joined Truffle in 2015 and brings extensive expertise across equity research and portfolio management. Nicole is recognised for her disciplined approach and deep research capabilities across South African equities.



AUTHOR

Saul Miller, FFA | Portfolio Manager & Analyst

Saul Miller is a senior portfolio manager at Truffle Asset Management with 27 years of industry experience. Since joining Truffle in 2016, he has played a key role in managing equity and balanced strategies. Saul is known for his strong analytical skill, consistent outperformance, and deep understanding of fundamental equity investing.



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info@truffle.co.za | +11 035 7337 | truffle.co.za

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