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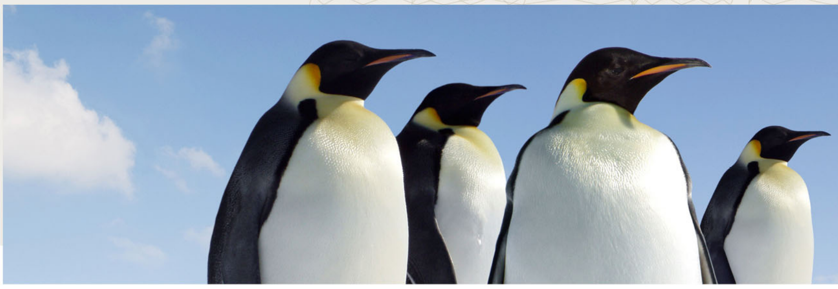

Nine out of Five - 2023 Outlook

The dominant investor view at this stage is that the US economy will move into a modest recession during 2023. As the world's largest economy, this would have a negative knock-on effect on global financial markets.

We are, however, surprised at how widely this view is held and the high degree of conviction it carries. The reason for our disbelief is that investors have a notoriously bad track record of predicting financial markets.

The Paul Samuelson quip reminds us of this: "Economists have correctly predicted nine of the last five recessions."

Then, of course, there is the other fact that there is no statistically significant correlation between GDP growth and stock markets. Even if you knew exactly what next year's GDP growth will be, this provides no predictive power regarding how stock markets will actually perform. This is because stock markets are nothing but discounting mechanisms, meaning that any news, positive or negative, is more than likely already priced in.

So, we will focus our comments on what may matter most in 2023 based on what we know at this point:

- US inflation and interest rate trajectory
- Chinese economic recovery
- Corporate cost-cutting
- Company valuations

US inflation will likely be the key vector for financial markets in 2023.

Many economic data points have already trended significantly lower, which will start to feed through to the official inflation data over the next 12 months. Additionally, the high inflation data will begin to fall out of the tail during the middle of 2023. With inflation, it is also essential to observe the rate of change rather than the absolute number. The rate of change is trending lower. For instance, the annualised rate of change in the core US CPI data over the last three months is 4.2%, which is substantially lower than the previous number of 6.1%.

As the trend of lower inflation becomes embedded, the Fed will likely change their hawkish tone. We will be astonished if the Fed funds rate goes much above 5.0% as the recent hikes are reducing inflation and the

Fed’s funds rate is already at a 14-year high. We believe the Fed will pivot during 2023 to avoid inflicting unnecessary punishment on the economy. This will be positive for risk assets, specifically stocks, and markets will likely recoup some of the ground they lost in 2022.

The Chinese economy has slowed down to levels not seen in many decades due to the restrictive impact of Covid-19 policies. These policies are being slowly dismantled, and we anticipate this will lead to increased economic activity from China. This will contribute positively to global GDP growth and improve sentiment. The gradual reopening of China will also ease supply chain congestion and further soften inflationary pressures.

Elon Musk's cavalier approach to cost-cutting at Twitter by decreasing its staff contingent underscores the bloated employee numbers at US tech companies and the overall level of corporate excess. Musk's infamous ultimatum email to Twitter employees to "commit to "working long hours at high intensity or resign" has set a new bar for cost-cutting for all executives. The downsizing by some tech companies, including Meta Platforms, which cut its staff contingent by 30%, is spurred by the economic slowdown. Alphabet has doubled its staff complement over the last few years and has been reluctant to reduce staff numbers. Their hand may now be forced. This trend will initially stabilise profits and then put the mega-cap technology companies back on a growth trajectory.

The S&P 500 is trading in line with its long-term price-earnings multiple, indicating that the market is fairly valued. Other developed and emerging stock markets are looking cheaper and trading at the lower end of their valuation ranges. There is a viewpoint that 2022 was about multiple compression, and 2023 will be about earnings contraction, placing further pressure on stock markets. We don’t subscribe to this view and believe the combination of a weaker dollar, Chinese reopening, corporate cost-cutting, lower inflation and the Fed pivot will be supportive for stock markets in 2023.

Our views on the key asset classes are best summarised as follows:

- **Global Equities** – Returns will not match what we have seen over the past decade but will revert to historical levels. This will still provide investors with capital growth that handsomely outpaces inflation. We continue to find that there are always opportunities, irrespective of the environment. We believe a barbell approach of investing in *value* and *growth at the right price* shares will reward investors. With interest rates normalising from the forgiving low base of recent years, investors will increasingly focus on traditional fundamental metrics like profitability, cash flow generation and balance sheet strength.

- **SA Equities** are exceptionally cheap, with valuations at historically low levels, but sentiment remains low because of lacklustre growth driven by load shedding and inept politicians. Any positive political changes will have a pronounced impact on SA equities, particularly if foreigners become net buyers again. Commodities will support the local bourse.

- **Rand** – the US dollar has been robust due to increasing US interest rates. As this cycle turns, we anticipate this vigour will diminish and that there will be a period of rand strength. *Long-term, we remain negative on the rand.*

- **Commodities** – a combination of a weaker US dollar and a reopening Chinese economy will bode well for commodities in general. Within commodities, we have concerns over bulk commodities but are favourably disposed towards commodities that are used in batteries and the electrification of vehicles, as well as those commodities that will benefit from the structural tailwinds as the world transitions to cleaner energy. We continue to believe that oil prices will remain firm due to underinvestment, Chinese reopening and the US replenishing their strategic oil reserve.

- **Bonds** – Generally, we are neutral on bonds as we don't expect that interest rates will revisit the lows of the last few years. Emerging market bonds could perform well, benefitting from local currency strength and yield compression.

- **Cash** is never a good long-term impact investment because of the corrosive impact of inflation. Tactically, it can provide some use to investors, as seen in 2022, but we don't think this situation will likely repeat.

Recent events such as the Ukrainian invasion and the Covid 19 pandemic show how unexpected events can quickly change the investment landscape. By their very nature, it is difficult to forecast these events, but if we gaze into our crystal ball, the next crisis may originate from the following geopolitical events:

- War – the Ukrainian conflict escalates to a new level as NATO is forced to intervene or China invades Taiwan.
- Regulation – Chinese companies listed in the US are delisted because they do not meet the audit requirements of the SEC.
- Inflation – the ongoing conflict between the US and China forces companies worldwide to onshore manufacturing production. This dramatically increases global inflation because access to China's low-cost manufacturing base is lost.

Bringing our outlook home, we outline how this filters through into our investment strategy.

Our investment strategy is built on long-term, time-tested, empirical evidence rather than any short-term and cyclical events. Core to our investment strategy are the following tenets:

- There is no correlation between economic growth and stock market returns.
- It is impossible to time the market.
- Stocks have historically outperformed all other asset classes.

With these principles, it is easy to formulate our investment strategy. We want to constantly invest in great companies that can compound their earnings and where we can acquire these companies at a reasonable price and, most importantly, remain invested in these companies for the long term. We accept that the price we pay for the higher returns from stocks is higher investment volatility.

Research Editor
Michele Santangelo
Simon Fillmore
Joe Klopper

Contact Details:

Johannesburg

39 Ferguson Road
Illovo
2196

P.O. Box 2849
Houghton
2041

Tel: (011) 489-5400
Fax: (011) 489-5499

Portfolio Managers
James Macmillan
Simon Fillmore
Peter Warren
Pierre du Plessis
Michele Santangelo

Pretoria

Hillcrest Office Park
Corner Dyer & Lynnwood Road
Hillcrest
Pretoria

P.O. Box 1514
Brooklyn Square
0075

Tel: (012) 362-2772
Fax: (012) 362-2760

Portfolio Managers
Harold de Kock
Joe Klopper
Greg Doig
Charlene Bester

Stellenbosch

153 Dorp Street
Stellenbosch
7600

P.O. Box 65
Stellenbosch
7599

Tel: (021) 882-8680
Fax: (021) 882-8664

Portfolio Managers
Johan van der Westhuizen
Roelof Feenstra
Angus Waugh
Lance Faure
Johnnie Solms
Steve Mills
Nicole van den Munckhof