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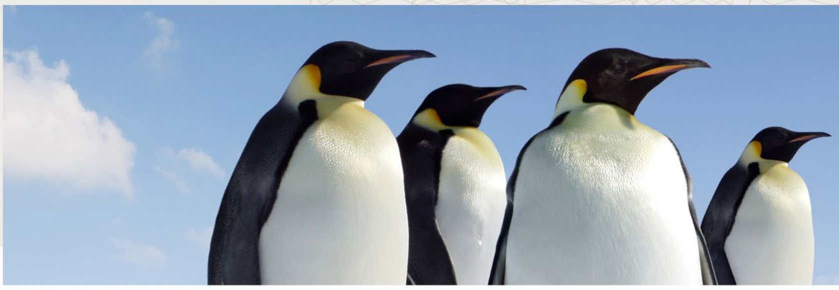

Friday, 7 October 2022

For Your Perusal

Highlighting Interesting Investment Research

Tactical Investment Opportunities

US equity market sell-off provides tactical offshore investment opportunities.

Markets are under considerable duress, mainly because the US Federal Reserve (Fed) has hiked interest rates faster than the market had anticipated to curb runaway inflation, pushing the US economy towards a recession. The Fed made a mistake by staying too low for too long, and is making another mistake by going too hard too fast. The US government updated its country's economic performance estimate for the last quarter and confirmed that it contracted for two consecutive quarters. This is widely used to define a recession, but not in the US which uses several other economic data points.

Higher interest rates, as well as aggressive monetary tapering by the Fed, has seen assets reprice. The stock market is nothing but a discounting machine, and the value of cash flows discounted back at a higher rate translates into lower valuations. The cheaper valuations now offer tactical investment opportunities for offshore investors.

There are several reasons offshore investments remain a sound diversification strategy, notwithstanding the volatility and uncertainty that has prevailed this year. One of which is the recent changes to South African Reserve Bank regulations, which now allow retirement funds to invest up to 45 per cent offshore.

The best-performing global asset class for the year to date has been US dollar cash, which usually is not the case in a high inflation environment, but the dollar has reigned supreme this year as investors have sought safety in the world's reserve currency and taken advantage of the significant increase in US interest rates, especially relative to other developed markets.

Bond yields have increased substantially this year to the point where bond investors have experienced bear market returns because when yields rise, bond prices fall. With the MSCI World index falling by 27% and the S&P500 down by 25% year to date, equity investors are deeply embedded in a bear market.

Investors generally remain pessimistic about the market outlook, with the latest retail and institutional investment surveys highlighting that investor sentiment is extremely negative. Historically, however, these surveys have proved to be contrarian indicators, and thus, when these investment surveys reach such low levels, the subsequent returns are extremely rewarding. Thus, savvy investors are taking advantage of the market moves by looking to the US market for tactical investment opportunities.

Dollar strength should not deter offshore investing:

The value of currencies can significantly impact investment returns, and there are different asset manager viewpoints on the outlook for the rand. We believe that the rand's volatility shouldn't be why investors defer investing offshore. It is impossible to time the market correctly, and one should invest for the long-term. That means investors should not necessarily wait for a strong rand to take advantage of offshore investment opportunities. Rather it is more important to systematically and periodically transfer funds offshore. Ironically, the rand tends to strengthen when global equities are performing well, and the rand is weak when global equities are underperforming. The point is that investors can buy cheap global equities now but have to use expensive rands to do so. If one were to wait for better levels on the rand, chances are global equities would have revalued relative to today's levels.

The long-term trend of the rand is glaringly obvious. Besides the Chinese-inspired commodity boom in the '00s, the rand has generally weakened. Foreign investors have been net sellers of SA equities for eight years. Unless there is a radical change in management style from the governing party (low/negligible probability) or the hydrogen economy results in excessive demand for SA natural resources (PGMs), the rand is highly likely to maintain its long-term trajectory. Although in the short-term, we would expect some strengthening from very oversold levels.

Equities are cheaply priced for mega-cap companies:

We see value in risk assets for the next 6 to 12 months and believe equities will provide capital growth for investment portfolios.

Inflation has surprised investors on the upside and, in our view, will most likely surprise them on the downside. US housing prices, a lagging indicator, are close to all-time highs, but US mortgage rates are at 20-year highs. Clearly something has to give, and we believe housing prices will come off the boil over the next year, significantly alleviating inflationary pressures. This will catalyse the Fed to become less hawkish and be positive for risk assets.

Lower inflation will be positive for bonds as yields decline, and equities will benefit too. We see greater value in equities and believe it is the asset class of choice, depending on specific clients' risk profiles.

Mega-cap shares in technology sectors will provide tactical investment opportunities:

Particular sectors in equities that we think will add value to investment portfolios in the future are the mega-cap shares in technology due to the strength of their balance sheets, which are not under any stress in the current environment, are generating positive cash flows and are highly profitable. Most importantly, many of them are trading at reasonable valuation levels.

Software as a Service (SAAS) companies were the poster boy for the major technology rally we witnessed over the last few years. However, the inflationary environment has increased the cost of capital, and

contracted margins and placed pressure on the balance sheets of many companies. However, we see significant value in mega-cap stocks, such as Microsoft and Adobe. Microsoft has been quite resilient through the stock market sell-off. In the Fintech sector, we see great entry points in Mastercard/Visa and PayPal and expect them to generate capital growth for investment portfolios.
Another way of diversifying risk while generating returns may be through incorporating alternative investment strategies. Market-neutral hedge funds can be a valuable addition to one's investment portfolio, smoothing out investment returns in periods of high volatility.

US and Asian markets outperform European counterparts:

Geographically, we believe the US and Asia offer better returns than Europe, with its many structural problems and considerable sovereign debt. Europe's population growth is slow and ageing. Younger generations consume and spend more, contributing to faster economic growth.

Within Asia, China is optically extremely cheap but has an increased risk profile. Issues such it's zero covid policy, technology company crackdown, US Securities and Exchange Commission (SEC) audit concerns and Taiwan have weighed heavily on investors' sentiment. Zero covid policy cannot run indefinitely, and the regulatory crackdown appears to have run its course. The first team from the SEC are currently conducting audits in Hong Kong, and if this is successful, it will remove the concerns over the delisting of Chinese ADRs on US stock exchanges. Access to global markets has uplifted Chinese per capita GDP exponentially over the last four decades and has been one of the major factors behind their renaissance. We don't believe it is the intention of the CCP to stop their long-term trajectory despite their many recent own goals.

From an emerging market perspective, South African equities are cheap, with a price-earnings (P/E) ratio below 10. The P/E ratio tells investors how a company is valued, and the South African long-term average is 15, so a lower P/E ratio is considered cheaper.

Another global sector that offers value is the energy sector, specifically the oil sector. Even before the Ukrainian crisis, we had identified that oil companies had significantly reduced their Capex over the last decade, and we concluded that markets were overestimating long-term global oil supplies. The Ukrainian crisis has exacerbated this problem. With less supply, we foresee sustained high oil prices, and investors can take advantage of these by adding energy ETFs to an investment portfolio.

Investors have different risk appetites and return objectives; thus, speaking to your portfolio manager before embarking on an investment strategy is critical.

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