Portfolio Manager Quarterly Comment

Market review

A review of the past year of 2023 very much resembles the volatility and turmoil that characterised the 2022 calendar year for the global investment environment. We commenced this past year with elevated risks on multiple fronts. Most prominent were lingering concerns related to inflation and rising interest rates in many markets, threats of recession in many regions of the world potentially, and lastly, geopolitical upheaval (at the time Russia remained at war with Ukraine). We now enter 2024 with a challenging combination of similar risks, albeit that a consensus has formed that we are now at the peak of the global interest rate cycle and while some lingering upside risks remain a concern for inflationary forces at the margin, overall this general thematic risk is a lot more contained in many regions of the world than it was this time last year. Unfortunately, geopolitical risks have accelerated with the addition of the Israeli-Palestinian conflict, which commenced in October last year and continues to pose an elevated risk to the wider Middle Eastern region.

The US economy has confounded sceptics this past year, delivering strong GDP growth momentum in the face of a sharp increase in the US federal funds rate over the last two years and corroborated by a strong performance by the US equity market in 2023. We entered the year with a historically reliable recession indicator in play for the US economy: two-year interest rates exceeded 10-year interest rates, inverting the US yield curve. This remains the status quo up to today and despite some closure of the gap due to a rise in the longer end of the US yield curve towards the end of last year (as mirrored globally in many markets), this highly regarded signal continues to call for an imminent recession in the US. While this may still play out, the overall narrative around the US economy has softened and an expectation of a softer landing has become more prominent. One of the key reasons for this remains the ongoing resilience in US labour markets, which continues to support US consumption and the dominant services mix within that economy. At the margin we've seen some softening of labour data here and there, but the unemployment rate in the US remains at decade lows. A softer US housing market and much higher interest rates relative to history do not seem to have compromised the US consumer, with many market proponents citing residual effects of historic economic stimulation that bolstered savings and the ability for US consumers to continue to spend.

This year may also prove to pose a state of flux for US economic policy, as the country faces a crucial presidential election in November 2024. While the US Federal Reserve (Fed) seems to have achieved a stabilisation of inflation, it has signalled that further interest rate hikes are unlikely, and the market has now turned its attention to the prospect of interest rate cuts. The timing of this remains very uncertain, given that the present higher interest rate regime has yet to tilt the US economy into a full-blown recession. Ultimately, it remains to be seen how this dynamic plays out this year and the risk of some form of recession in this very important economy globally continues to be a feature of our scenario analysis, albeit that it may transpire as a more shallow, shorter-lasting recession. What we do observe is that very high levels of uncertainty and difficulty with forecasting these dynamics have led to the market becoming very short-term orientated and 'news flow-driven', exacerbating market turbulence as important economic data are systematically released.

Across in Europe, more challenging dynamics have plagued this geographic collection of economies. Here, we have seen recessionary forces at play and a far weaker growth trajectory than the resilience that has characterised the US. While the UK has narrowly averted a recession, despite multi-decade high interest rates, the same can't be said for many European countries that have experienced contractions within their economies this past year and remain under considerable stress going into 2024. While the damaging impact of rampant energy prices and supply bottlenecks that plagued European economies going into 2023 have largely subsided, decreased household spending, high interest rates and ongoing geopolitical turmoil in Eastern Europe remain key threats to this broader region. The entire structural positioning of Western European economies continues to shift in the aftermath of a cut-off of Russian energy in the form of both oil and gas, much of which is now being diverted to China and to alternative trading partners that are willing to take Russian commodities. We expect this impact to reverberate across European economies over the next few years, as they reposition their manufacturing and industrial bases in response to this. A spillover from the unrest in the Middle East and its impact on the Mediterranean Sea has the potential to place further pressure on Europe, with many shipping companies already diverting their geographic route to now travel around the South of Africa to facilitate key seaborne trade. At the same time, long-term demographic challenges continue to accelerate slowly and pose great structural risk to many European economies. So while we do not expect deep and protracted recessions to play out in the key European economies in 2024 (the UK, Germany and France being the most important), we see this region as remaining in a state of flux, with the only silver lining likely to come from any prospective declines in interest rates that may be announced by the European Central Bank or the Bank of England during the course of this year.

On asset class returns, the MSCI All Country World Index (ACWI) returned 11.1% in US dollar terms, driven mainly by a P/E rerating of 10.5%. The MSCI World Index (i.e. excluding emerging markets) was up 11.5%, with the MSCI Emerging Markets Index up by 7.8%, with the latter driven by the performance of South Korea (14.1%), India (12.2%) and Taiwan (11.7%). The US Dollar Index weakened by 4.6%, with developed market bonds rallying by 8.1% and developed market net real estate up 18.1%. Locally, the FTSE/JSE Capped Shareholder Weighted All Share Index (Capped SWIX) was up 8.2% and listed property up 16.4%.

Asset allocation

It was a notable risk-on quarter, with the MSCI ACWI returning 11.1% in US dollar terms, driven mainly by a P/E rerating of 10.5%. The MSCI World Index (i.e. excluding emerging markets) was up 11.5%, with the MSCI Emerging Markets Index returning 7.8%, with the latter driven by the performance of South Korea (14.1%), India (12.2%) and Taiwan (11.7%). The US Dollar Index weakened by 4.6%, with developed market bonds rallying by 8.1% and developed market net real estate up 18.1%. Locally, the Capped SWIX was up 8.2% and listed property up 16.4%.

Most of the strength in this quarter's rally was experienced in November coming off a quite challenging October for markets. A significant factor driving markets was the continued reduction in US year-on-year core CPI, from 4.1% in September, 4% in October and 4% in November. This improvement in US core CPI increased the market's expectation of rate cuts arriving sooner than expected. Surveys are also showing an improvement in December to 3.8%. US year-on-year headline CPI also moved in the right direction, from 3.7% in September, 3.2% in October and 3.1% in November. We do await the next print, however, with expectations showing an increase to 3.3% for December.

Major changes made over the quarter include a reduction in global equity (i.e. local plus foreign) and increase in global cash. Overall, cash and bond yields remain attractive and we continue to harness these while on offer. On global equity, we still prefer SA over emerging markets over developed markets based, not least, on various valuation metrics. We remain underweight SA listed property given the attractive yields from SA bonds, at lower risk than the former. We continue to prefer SA nominal bonds over SA inflation-linked bonds.

Looking ahead, US core CPI still remains sticky and despite the continuing reduction in US CPI prints, it is not yet within the Fed's desired 2-3% range. This reduces the likelihood of Fed rate cuts soon and increases the probability that rates remain higher for longer. Moreover, the US labour market is still running hot, and the Fed wishes to see it cool down before potentially pivoting on rates. Globally, rising bond yields have resulted in markets migrating from TINA (there is no alternative) to 'there is now an alternative', viz. bonds. Higher bond yields have increased the opportunity cost of holding equities and reduced the opportunity cost of holding bonds; this is accentuated in SA.

Short-term interest-bearing (STIB) instruments

The South African Reserve Bank (SARB)'s Monetary Policy Committee (MPC) kept rates unchanged over the quarter, leaving the repo rate at 8.25%. The bank's latest forecasts are that 'headline inflation for 2023 is revised down slightly to 5.8% (from 5.9%). The headline inflation forecast for 2024 is 5.0% (down from 5.1%), before stabilising at 4.5% in 2025 and 2026.' In relation to core inflation, it has been revised down 'to 4.8% in 2023 (previously 4.9%) and to 4.6% in 2024 (from 4.7%). The core inflation forecast for 2025 remains at 4.5%. The new 2026 core forecast is also 4.5%.'

Given the risk-on quarter, money market curves fell notably, with the three-year fixed-rate negotiable certificate of deposit (NCD) yield moving down 59 basis points (bps) over the quarter to 8.77%, while the five-year fixed-rate NCD yield increased by 69 bps from 9.96% to 9.27%. Three-year floating-rate note (FRN) spreads increased by 20 bps, from 77.5 bps to a yield of currently three-month JIBAR + 0.975%, with the yield on five-year FRNs also increasing by 0.2% over the quarter from 97.5 bps to a yield of three-month JIBAR + 1.175%.

Despite the fall in global yields, cash and bond yields remained attractive after adjusting for SA inflation. Corporate credit spreads remain tight, warranting a conservative stance on this sector based on both current pricing as well as fundamentals.

Equities

For the past quarter (Q4-2023), the top three contributors to performance were the following positions held: our overweight exposure to Anglo American Platinum, underweight exposure to Sibanye-Stillwater, and overweight exposure to Northam Platinum. For the past full year (2023), the top three contributors to performance were the following positions held: our underweight exposure to Sibanye-Stillwater, overweight exposure to Datatec Limited, and underweight exposure to Capitec.

We commenced the year with an overweight exposure to PGM shares in the fund. During the year, we pared back this exposure due to concerns around the challenges facing the industry, such as dramatically falling PGM commodity prices as well as concerns around the longer-term potential structural demand for PGMs, considering the sharp rise in the production of electric vehicles across the globe. In the final quarter, we concentrated our exposure in two key PGM investment cases, namely Anglo American Platinum and Northam Platinum, and tactically increased our exposure to these specific shares, considering the dramatic sell-off across all the PGM shares that we saw in the second half of last year. Both investment cases were scrutinised and selected for their long-term merits and the fact that they have well-positioned mining resources that can withstand the current malaise in PGM share prices (cost curve positioning, scale of operations, etc.). At the same time, the collapse of their respective share prices offered a significant investment opportunity, when the market was clearly avoiding exposure to this area of the market.

Our enduring overweight exposure to Datatec added value again this past year, as the company delivered on its stated objectives and our long-term expectations of the investment case. The company reported robust financial results last year that were ahead of expectations, benefiting from the fact that their niche offering of services remains firmly in demand within the technology landscape. The long-term investment thesis for the share, which involves unlocking our assessment of intrinsic value through deliberate strategic actions, remains intact and it was pleasing to see the market rewarding the investment case for a third year in a row now.

Capitec was another positive contributor to the performance in 2023. We had no exposure to Capitec in the first half of last year, as the share price fell sharply. The share came onto our radar after this negative performance, and after repeatedly scrutinising the investment case within the team, we added exposure to the share when we felt comfortable that value was emerging. On a net basis, through the course of the year, we were underweight Capitec, but our decision to add exposure timeously, as the share recovered, added value to the fund. Our analysis showed that the investment case depicts a rapidly evolving, high-growth investment that continues to deliver across multiple growth levers – a strong, transactional retail client franchise, a nascent disruptive business banking offering, and lastly, a lucrative insurance offering that is also at the early stages of its evolution. The ability to monetise a large and extensive client base effectively remains the key underpin to the Capitec investment case. The market gave us an opportunity to obtain exposure to this investment case at very attractive levels last year that adhered to the parameters of our investment philosophy and was not at the previous lofty levels that this share typically trades at.

For the past quarter (Q4-2023), the top three detractors from performance were the following positions held: our overweight exposure to Pick n Pay, underweight exposure to Gold Fields and overweight exposure to Sasol. For the past full year (2023), the top three detractors from performance were the following positions held: our overweight exposure to Pick n Pay, overweight exposure to KAP Limited and underweight exposure to Gold Fields.

SIM equity strategy

As we enter this next year, several issues remain unresolved and unclear. While we can clearly support the fact that we are at the peak of a challenging global interest rate cycle, it is yet to be ascertained where the environment settles, how inflation evolves around the world and where interest rates ultimately recede back to. We have a clear sense that they will need to be higher than history, which implies a higher cost of capital than the investment world has become accustomed to in recent times. This poses a challenge to equity valuations, and we are incorporating these debates into our views and our process. At the same time, we see the year ahead as being fraught with economic growth challenges in many regions of the world – potentially the US, in Europe and likely in China. This means that a broad-based, typical business recovery is not expected to play out as it has in previous cycles and that there are more nuances in the current environment that we need to consider. We also need to overlay structural longer-term challenges such as climate change, the green agenda, ageing demographics, and geopolitical upheaval, all of which move slowly, but have a material influence on the environment that we are navigating.

Bonds

As with several other risky assets, most of the quarter's return from bonds came through in November, after a relatively challenging October. We remain partial towards in particular SA nominal bonds given their attractive real yields.

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For the quarter the All Bond Index returned 8.1%, the inflation-linked bond index 6.1% and the Alexander Forbes Short-Term Fixed-Interest (STeFI) Index 2.1%. The major driver of global bond yields has been the 69-bps reduction in the US generic 10-year bond.

International

The Fed's rhetoric has been notably more dovish this past quarter with Fed president Powell indicating that rate cuts have been discussed, which really fuelled markets. Added to this, the federal funds rate was kept unchanged at 5.25-5.50% and expectations are for it to remain so at the upcoming Fed meeting. The Bank of England also kept its rate unchanged at 5.25%, on the back of improved UK CPI prints. The major driving force behind this quarter's rally was the improved US CPI prints, as discussed elsewhere in the report. We do watch the next few releases closely, however.

2024 is certainly a busy year vis-à-vis country elections, with most likely the most important of these being that of the US. Although Trump has been barred from at least two states' ballots, he's still doing quite well in the polls. Elections will also be taking place in our country, Germany and India, among others. We watch these developments closely.

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