03.

Adviceworx

Investment *Outlook*

Eighteen months later and the global economy is finally on firmer ground as economies have reopened and activity has started to normalise. While over three billion vaccines have been administered, new variants continue to pop up, prolonging a return to normalcy. Sadly, the divide between vaccinated rich countries and unvaccinated poor countries will widen, laying bare the economic fault lines exacerbated by the pandemic. Unprecedented government support which cast a life line to vulnerable economies during the nadir of lockdowns has now left markets worrying if this life support could trigger soaring inflation, reminiscent of the 1970s. Central banks will have to negotiate a fine balance between withdrawing economic stimulus to avoid overheating their economies while at the same time not doing so too quickly to avoid tightening monetary conditions too much. Emerging markets outside of China are vulnerable as their slow vaccination programmes have weakened their recoveries and now face the prospect of higher global interest rates as the Federal Reserve looks to reduce its bond buying programme which has anchored bond yields. Emerging market currencies and elevated equity markets have started to wobble at the prospect of tighter monetary conditions. While the pandemic necessitated unprecedented action by central banks and governments, an orderly exit from loose monetary and fiscal policy looks increasingly fraught with challenges. The margin for error has become increasingly slim and any misstep could unnerve capital markets which have become long accustomed to drinking from the low interest rate punch bowl.

International

Variants and uneven vaccine rollouts

The global economy is finally on firmer ground as economies have reopened and activity has started to normalise. The largest threat to a more enduring recovery is the emergence of new Covid-19 variants which could evade vaccine antibodies. The Delta variant poses a risk given its much higher infection rate, making it nearly impossible to achieve herd immunity. Thankfully, vaccination rates have ramped up significantly which should encourage greater mobility and economic activity. However, vaccination rates have varied significantly across countries. Nearly 48% of Americans are fully vaccinated compared to 38% of all Europeans, whereas Asia has lagged considerably. Japan which insisted on lengthy domestic trials before approving and securing vaccines has vaccinated only 18% of its population. Indonesia, Taiwan, Thailand and South Korea are facing rapidly rising incidences of the Delta variant, prompting tighter lockdown restrictions at a time when vaccine supplies are hard to come by. Slow vaccination progress could hurt Asian economies which in turn will have broader implications for the global recovery.

By contrast, America which has had the benefit of abundant vaccines and ample government support runs the risk of overheating. Economists expect that the economy grew by 9.1% in the second quarter on an annualised basis. This will be the best year of growth since the early 1980s. America is also experiencing an unusual combination of high job openings and high unemployment. Usually when unemployment rises, job openings fall because employers have an abundance of workers from which to choose. Excess labour should in theory keep wages in check. Today, there are lots of job openings, but unemployment remains relatively high and wages are increasing. The aftermath of the pandemic has resulted in some interesting developments in the US labour market. Generous government assistance may have delayed the return of many displaced workers, creating labour shortages and forcing businesses to ramp up wages to attract workers. Workers in the leisure and hospitality sectors who lost their jobs during the pandemic are looking for jobs in other sectors. The pandemic has also accelerated the knowledge-economy, increasing the demand for highly-skilled workers.

Inflation – should I stay or should I go?

US core inflation, which excludes more volatile items such as energy and food, rose by 4.5% in June, a level last seen in January 1992. Robust consumer demand supported by plentiful household savings, supply shortages and higher import costs have driven up goods price inflation. The US labour market remains tight. Wages are rising sharply despite a 5.9% unemployment rate which is still well above pre-pandemic levels of 3.5%. The burning question for the markets is whether higher US inflation will be transitory, meaning interest rates can stay lower for longer, or that price increases have indeed become more persistent. The risk is overreacting to temporarily higher inflation and slamming on the policy brakes too soon and harming the nascent recovery. However, if prices turn out to be stickier than expected, this may compel the Fed to tighten monetary policy earlier than expected.

Mixed signals

Under normal market conditions, the slope of the yield curve can provide important hints about inflation expectations and the direction of the economy. In the first quarter of 2021, the slope of the US Treasury yield curve was understandably steep i.e. long-term yields were rising faster relative to short-term yields because economic growth had accelerated and the market was starting to price in higher inflation which usually results in higher interest rates. The bond market was reacting the way investors expected it to. Yet in April the yield curve started to shift again. Predictably, short-term yields started to rise following a more hawkish update from the Federal Reserve which intimated that it might need to increase interest rates sooner than previously anticipated. The befuddling move was at the long end of the yield curve, where instead of yields rising in response to long-term growth or inflation expectations, they in fact fell. The 10-year yield has fallen from 1.70% in March to around 1.30%.

What could the bond market be suggesting? Possibly that the peak in economic growth has passed since markers of economic activity such as new orders and commodity prices appear to have peaked. While core inflation remains elevated, more importantly US inflation expectations have recently fallen back to levels consistent with the Federal Reserve's inflation target. Fiscal stimulus initiatives that provided developed economies with a much needed shot in the arm are likely to come to an end, meaning future growth may not be as easy. This would cause bond yields to fall. Perhaps the bond market is validating the Fed's view that inflation will be transitory and the higher rates of inflation we have seen over the last few months will normalise once economies have fully reopened and supply bottlenecks have eased. But could the bond market be wrong about inflation? If prices prove to be stickier than expected, bond yields will have to rise. The Fed will also be looking to reduce its bond buying programme, an important anchor for bond yields. This poses another risk to the bond market and by extension the equity market that has benefitted from ultra-low interest rates. As the markets digest incoming economic data coupled with a taper in Fed support as well as the trajectory of the virus and its variants, markets could be in for a choppy third quarter.

South Africa

Fragile recovery weakened by the Delta variant and social unrest

South Africa finds itself at the epicentre of Africa's third Covid wave. The Delta variant has rapidly replaced the Beta (South African variant identified during the second wave of the pandemic). Public and private hospitals are under significant strain. Gauteng which is home to about a quarter of the country's population accounts for more than half of daily cases. Excess deaths in Gauteng are the highest ever recorded.

A third wave which has prompted another lockdown coupled with a painfully slow vaccination programme and the potential threat of load shedding could derail the economy's recovery. The Organisation for Economic Co-operation and Development (OECD) expects South Africa to recover to pre-pandemic levels as late as 2025, one of the slowest economic recoveries in the world. Countries that have vaccinated their citizens have seen a quicker recovery in their economies. In the absence of an accelerated vaccination programme, South Africa faces the gloomy prospect of facing multiple waves of Covid-19, which may require varying degrees of lockdown, all of which will hobble a battered economy.

It is too early to assess to what extent GDP growth and inflation will be impacted by the recent spate of social unrest which resulted in the destruction and loss of property. At its last MPC meeting, the SARB estimated that the economy should grow by 4.2% in 2021. The negative impact on the economy as well as consumer and business confidence could weigh on Q3 GDP growth. This may prompt the SARB to adjust their growth prospects downwards. Disruptions to logistics and supply chains could lead to a short-term increase in prices for food, medical supplies and fuel. Provided the unrest can be quickly contained and supply chains restored, this should not have a material impact on inflation. Headline inflation is expected to average 4.3% in 2021 and 4.2% in 2022. The SARB has forecast an increase in the repo rate of 0.5% in the fourth quarter of this year and another 1% increase in 2022.

Tactical Asset Allocations

Domestic asset classes

Domestic **Equity**

Slightly Underweight

Earnings

- The SARB has revised its expectation for SA's GDP growth upward to 4.2% for 2021 from 3.8%, supported by higher commodity prices, a recovery in household spending and generally supportive global conditions. Household spending is expected to recover as lockdown restrictions are eased and further aided by low interest rates.
- Earnings growth expectations have improved from the beginning of the year. Earnings are expected to grow by 66.5% in 2021, albeit from a low earnings base, thereby reverting to 2019 earnings levels at the end of the year. Beyond 2021, the earnings picture looks gloomy, with earnings expected to grow in the high single digits.

Valuation

- South African equity is cheap relative to its developed and emerging market peers. The market has not recovered to the same extent as its peers during the recent reflation or reopening trade.
- Relative to its history, the 12-month forward P/E of 9.8x is trading at a 21% discount relative to its 15-year average of 12.4x.

Asset allocation view

- Domestic equity is trading at undemanding valuations. Global factors remain supportive and SA equity will benefit from improving global economic growth, developed market fiscal stimulus, a recovery in global trade, a weaker dollar and stronger commodity prices.
- While risks to growth will remain until we see progress on reform, a lot of pessimism is already in the price and companies appear in a stronger position to navigate this environment.
- The uncertain outlook for earnings growth beyond 2021 underpins the slight underweight allocation to domestic equity.

Domestic **Listed Property**

Underweight

Fundamentals

- Rental collection has improved to between 90% and 100% but could potentially weaken as further lockdown restrictions were implemented to contain the third wave.
- Retail vacancy rates have increased to 6.5% in March with neighbourhood malls experiencing the largest rate of vacancies. Open air convenience malls have been more defensive as consumers opt for convenience and open-air shopping.
- Office vacancies continue to rise, reaching an all-time high of 15%. This has put significant pressure on rentals which have experienced negative growth over the last year and rental reversions are also negative. It is expected that the office market will remain under pressure for the foreseeable future.

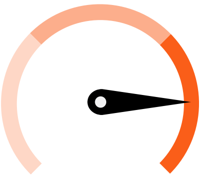
Valuation

- The sector trades at a 20% discount relative to net asset values.
- Following recent strong price performance, domestic property looks relatively less attractive to domestic bonds, as property yields trade at a premium relative to the SA 10-year government bond.

Asset allocation view

- Domestic listed property is cheap, but the risks to dividends and growth in 2021 remain to the downside given strong fundamental headwinds and substantial leverage. Relative to domestic property, domestic bonds offer a better risk-adjusted yield.
- Maintain maximum underweight to this asset class.

Domestic **Fixed Income**



Overweight

Nominal bonds

- Nominal government bond yields are attractive relative to cash, inflation and emerging market bond peers.
- Strong commodity prices have increased export income which has boosted the national fiscus. As a result, National Treasury has been able to reduce its bond issuances, a positive outcome for the bond market.
- The steepness of the yield curve relative to other emerging market peers suggests that there is a significant risk premium embedded in South African government bonds.
- Notwithstanding the fundamental risks facing the bond market such as a very high debt to GDP ratio and weak economic growth, nominal bonds remain attractive from a valuation perspective.

Inflation-linked bonds

- Inflation-linked bonds provide protection should inflation be higher than expected. For shorter maturity bonds (5 years or less), inflation linkers look attractive relative to nominal bonds because of the high real yields on offer.

Credit

- A high level of risk aversion has increased the demand for high quality issuances. As a result of demand exceeding supply, credit yields have fallen.
- Valuations remain expensive and yields do not reflect implicit credit risks.

Asset allocation view

- Remain overweight with a preference for nominal government bonds.

International asset classes

International **Equity**

Overweight

Earnings

- A continued uptick in global growth and rising earnings should provide a tailwind for equities. Global 12-month forward earnings are trending higher, with companies beating expectations. Companies are also more optimistic than normal regarding their earnings guidance.
- Earnings for the US are expected to increase by 36.4% in 2021 and reach more normalised levels in 2022 (10.7%) and 2023 (10.4%).
- The US stimulus package should be beneficial for non-US markets leveraged to global trade.
- This will bode well for corporate earnings in 2021. Earnings expectations for the Eurozone, United Kingdom and Emerging Markets, relative to the US, are showing tentative signs of improvement.

Valuation

- Valuations for the US equity market are expensive relative to history. Its forward price to earnings (P/E) multiple of 22.3x is trading at a 34% premium to its long-term median of 14.8x.
- Compared to the US 10-year treasury bond yield, equities look more fairly priced.
- While the forward P/E of the United Kingdom (12.7x) and the Eurozone (16.3x) trade at more reasonable valuations, they are still expensive relative to history.
- Emerging markets valuations appear undemanding relative to developed markets with a forward P/E multiple of 13.8x, which is in line with its long-term average relative to developed markets.

Asset allocation view

- Retain overweight position to international equity given its better earnings growth expectations and geographical and sector diversification.

International **Listed Property**

Neutral

Fundamentals

- Sectors such as lodging and hospitality should receive a welcome boost as economies reopen.
- While it is still too early to assess the longer-term impact of the work-from-home trend, global office vacancy rates have started to tick up. This will put downward pressure on rental rates, which are expected to fall in the region of 5% in North America and the United Kingdom.
- The retail sector faces structural headwinds as retailers continue to cut stores. Open air malls have been relatively more defensive relative to traditional shopping malls.
- A rise in global interest rates could be negative for global property in the short term as bond yields rise. However, in the medium term, global property can provide some inflation hedge as rentals are adjusted upwards to account for higher inflation.
- After falling 2% last year, funds from operations which is equivalent to cash generated by operations is expected to grow 7.6% in 2021 and 8.4% in 2022.

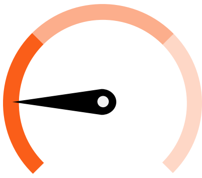
Valuation

- A dividend yield of 3.2% is attractive relative to 10-year bond yields of 1.32%. Global property trades at a 1.89% discount to bonds.
- Following a rally in global REIT share prices in Q2 (+9.96% versus global equities of 7.88%), global property is trading above its long-term valuation metrics and is looking expensive at a forward price to funds from operations of 24.7x.

Asset allocation view

- Retail and hospitality are expected to recover slowly and will continue to lag other sectors.
- Sectors expected to remain robust in a post-Covid world are data centres, data towers, industrials and select residential.
- Retain neutral weighting.

International **Fixed Income**



Underweight

Fundamentals

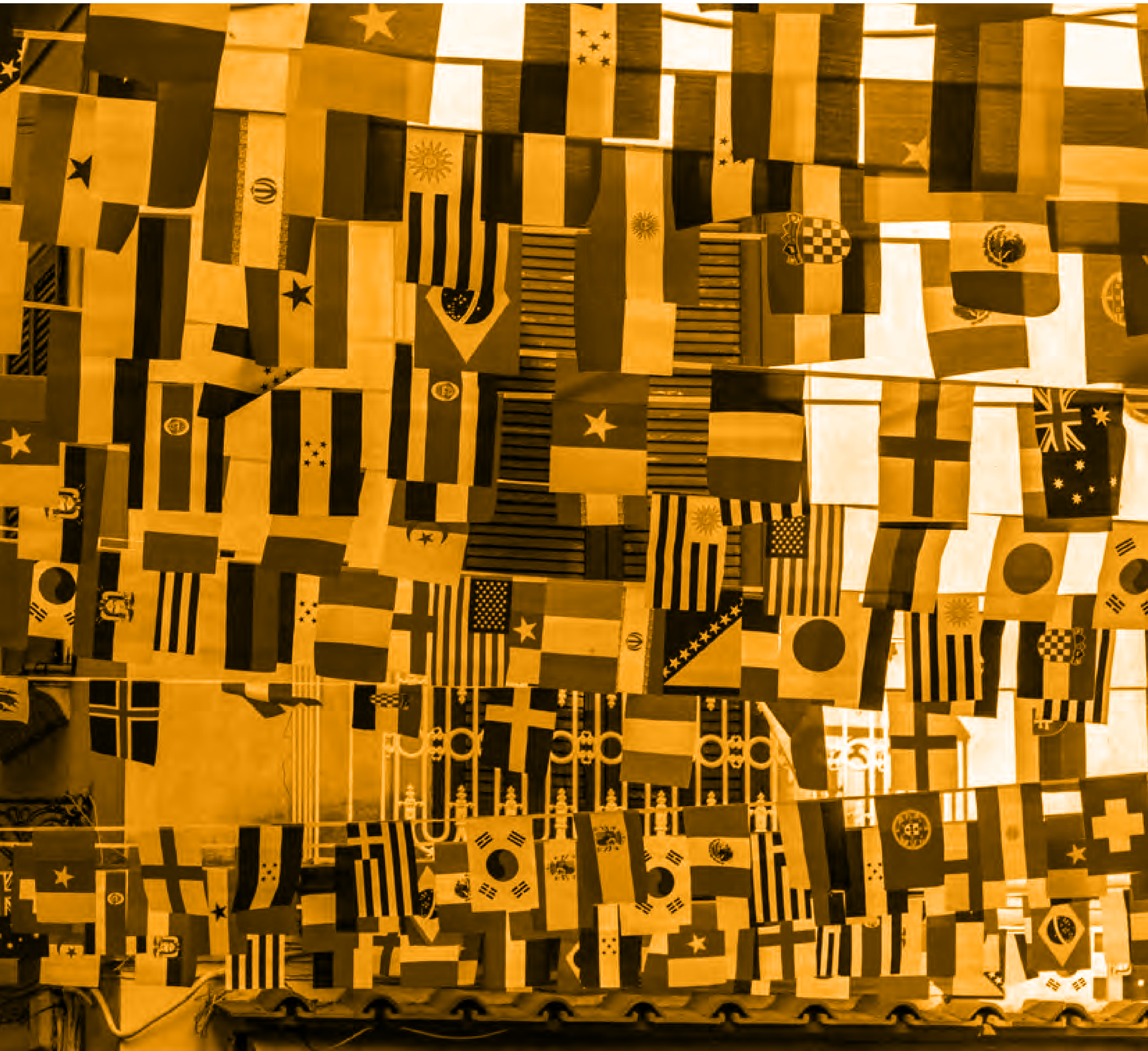
- Bond markets are expected to be choppy as the markets navigate incoming inflation data and the withdrawal of central bank support.
- Core inflation remains elevated, but it is too soon to assess if the rise in inflation is transitory or risks becoming stickier.
- Despite rising short-term inflation, inflation expectations for the next 5 and 10 years have subsided.

Valuation

- USD cash and government bonds are expensive.
- Investment grade credit has become relatively more expensive following a tightening in credit spreads.
- High yield credit is relatively more attractive than investment grade fixed income.
- Emerging market bonds are more attractively priced relative to developed market bonds. A recent strengthening in the USD and a rotation out of emerging markets has made EM bonds more attractive on a valuation basis.

Asset allocation view

- Retain underweight position given low yields.



Adviceworx

Adviceworx (Pty) Ltd
1st Floor, Building 5, Commerce Square
39 Rivonia Road, Sandhurst, Johannesburg, 2194
T +27 (0) 11 268 9600 F +27 (0) 11 268 9635
E service@adviceworx.co.za
W www.adviceworx.co.za

Data sources

- Market returns: FactSet
- Earnings estimates: IBES, Thompson Reuters Avior and JP Morgan
- Global growth forecast: International Monetary Fund