MARKET & ECONOMIC UPDATE

INVESTMENT WEEKLY

Adviceworx
Professional Financial Advice

DECEMBER 13, 2021

GHOSTS OF THE PAST, PRESENT AND FUTURE

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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."

So begins Charles Dickens' Tale of Two Cities. It might be the best opening line to a novel in all English literature and also seems to perfectly capture investing in 2021. Returns have been fantastic despite extreme doubt and uncertainty, while risks lurked around each corner.

There has certainly been plenty of foolishness, as a new generation of day-traders have pushed meme stocks, special purpose acquisition companies (SPACs) and cryptos to ridiculous levels. Battle-hardened investment professionals have not been immune to bouts of irrational exuberance either.

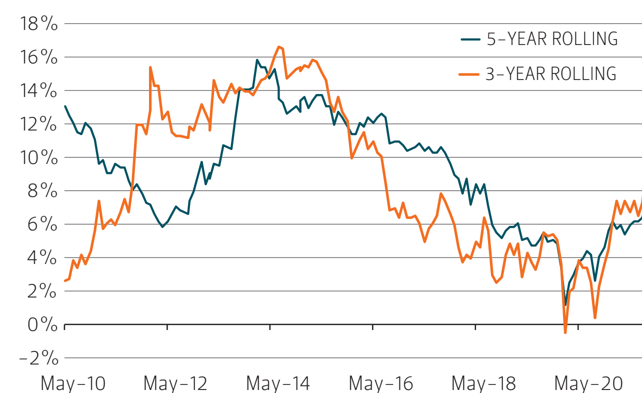
As for wisdom, let's just say that investors were rewarded for staying the course during very trying times at home and abroad. Despite everything, hope and despair walking side by side, investment returns from a typical South African balanced fund have increased since the start of the pandemic. None of this was obvious at the time, while with hindsight it is. In the moment, it required incredible fortitude.

SEEING GHOSTS

Speaking of Dickens, and since the festive season is upon us, we can borrow from A Christmas Carol to think about the investment ghosts of the past, present and future.

There are many of course, but for the ghost of the past let's elaborate on disappointing returns of recent years.

Chart 1: Returns for the average of the ASISA SA Multi-Asset High Equity category



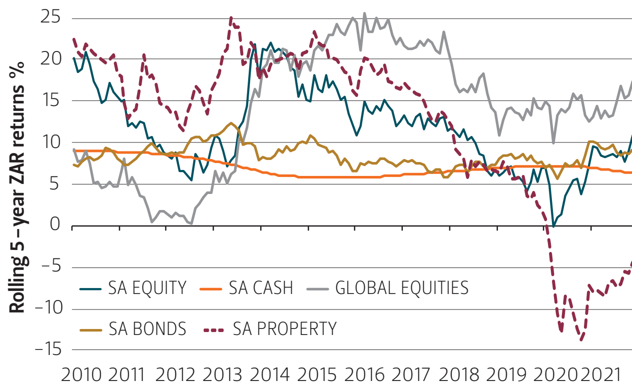
Source: Morningstar

Roughly speaking between 2017 and 2020, investors would have seen the returns from their traditional South African balanced fund lagging cash, even looking back over five-year periods (each point on chart 1 represents three or five-year returns). They took on additional volatility for reasonably long periods without reward. The frustration was understandable. But now returns are pulling ahead, partly because cash returns have followed the repo rate lower, but mostly because SA equity returns have improved significantly.

Even before the Covid panic of 2020, South Africans experienced lacklustre returns, apart from global equities. Most retirement funds are limited to 30% global exposure, meaning that JSE-listed equities will by default be the main growth asset in such funds.

South African equities struggled, with rolling five-year returns falling below cash in 2018 and remaining so until last year. Many assumed that this is because of corruption or loadshedding or other governance-related problems. However, these problems are still very much with us, but returns have improved. In fact, this year saw devastating riots and looting, loadshedding and record unemployment. In contrast, 2018, the year that Jacob Zuma resigned and all our problems supposedly went with him, saw the JSE deliver its worst performance in a decade because global markets sold off.

Chart 2: Rolling five-year annualised asset class returns in rand



Source: Refinitiv Datastream

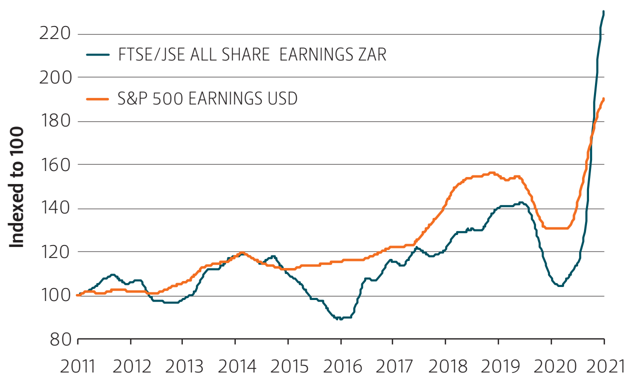
The main reason for the disappointing returns from JSE-listed equities is that there was no earnings (profit) growth between 2015 and early 2018.

Today, JSE earnings are at record levels and it is therefore no surprise that the market is also near an all-time high. The same is true for the US market.

Just as mining companies were largely behind the 30% decline in earnings between 2015 and 2016, they were the main contributors to the doubling of earnings from the low of mid-2020.

The only asset class that has deteriorated badly is SA listed property. While it rebounded sharply during the year, it is still deeply negative on a five-year basis. The sector was particularly hard hit by Covid, since it largely depends on providing a physical space for people to congregate (hotels, malls and office buildings). The logistics and warehousing subsector has done well in South Africa and globally, but the local benchmark is dominated by retail and office, in contrast to the much more diversified global benchmark.

Chart 3: 12-month historic earnings



Source: Refinitiv Datastream

A DISTORTED WORLD

The ghost of the present is Covid, which is still very much with us. In fact, the world is currently experiencing a pronounced fourth wave, and this is even before the highly transmissible Omicron variant spreads wildly.

The good news is that all the evidence so far suggests that Omicron causes a less severe form of Covid than earlier variants. South African confirmed cases have rocketed, but hospitalisation is still low, and hospitals are reporting fewer patients requiring oxygen. Preliminary studies also suggest vaccines do a reasonable job against the new variant, though booster shots will probably be required.

This doesn't mean that Omicron won't be disruptive. If it proves less deadly than earlier variants it will be a great relief, but the fact that it spreads wildly still means workers quarantining at home. This could add to the existing strain on global supply chains. After all, the knee-jerk travel bans are still in place.

In other words, the world is far from normal. We feel it in our daily lives and it still distorts the global economy. It is the main reason why we've had this unusual cycle with inflation surging in many countries.

Inflation has largely been driven by the inability of the supply side to respond to a sudden and unexpected surge in demand. This jump in demand was partly fuelled by fiscal and monetary stimulus, but mostly because consumers shifted spending from services to goods during the pandemic. Getting back to normal will take longer than anticipated precisely because beating the virus is proving so difficult. The problem is that whatever the root cause, the longer inflation persists, the greater the chance that it becomes entrenched. The only way to get rid of it then is by squeezing the economy through much higher interest rates, as Brazil's central bank did last week, hiking its policy rates by 150 basis points to 9.25%. It was 2% at the start of the year.

Which brings us to the ghosts of the future. These are numerous and at this time of year there is no shortage of crystal ball-gazing, highlighting risks. Conflict between the West and Russia over the Ukraine suddenly seems a possibility, while a similar stand-off with China over Taiwan has long kept geopolitical experts awake at night. But for our purposes the big ghost of the near future is surely the US Federal Reserve.

ALL ABOUT THE FED

It will meet this week and likely announce an accelerated schedule of tapering its monthly bond purchases, bringing the end date forward from mid-2022 to around March. This would not be a surprise and should therefore not unsettle markets.

And there is no reason for the Fed to continue buying $120 billion in bonds, of which $15 billion is mortgage-backed securities. With house prices growing 20% a year and lack of supply a bigger problem than lack of demand, the property market clearly does not need additional stimulus.

The big question that investors are grappling with is what next? The Fed is likely to then start raising interest rates, but at what pace? And where do they end?

The Fed itself has previously said it thinks interest rates will reach 2% by end 2024 from almost 0% today. Markets are pricing in higher interest rates. The yield on the two-year US Treasury bond increased from 0.1% to 0.7% during the year.

In other words, while everyone expects higher rates, not everyone is positioned for much higher rates. The big risk is therefore that the Fed hikes even more than currently priced in by markets.

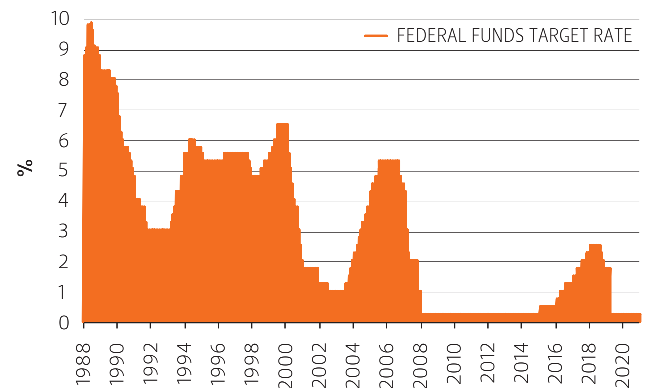
Higher rates by themselves are not necessarily a problem for equities. Interest rates typically rise when economic growth is strong and therefore coincide with periods when company profits are expanding.

Viewed that way, it would also be very problematic if the Fed and other major central banks don't get around to raising interest rates and ending quantitative easing. It would tell us that the global economy is very weak. That would hardly be good for equities, though long bonds would rally.

As with most things in life what is required is balance, just the right amount of policy tightening, not too much, not too little.

The danger scenario is that persistently elevated inflation rates erode consumers' real spending power, but the Fed is forced to act tough to keep inflation expectations under control. Interest rates will hurt the economy and therefore profit growth and cause lower equity multiples. But what exactly is the breaking point? Since the 1980s each successive interest rate cycle in the US has had a lower peak (this is the case for South Africa too). The 1989 cycle peaked at 9%, the 2000 cycle at 6.5%, and 2006 at 5.25%.

Chart 4: Federal Funds rate and 10-year US Treasury yield, %



Source: Refinitiv Datastream

BAH! HUMBUG!

In late 2018, the Fed funds rate rose to a measly 2.25%, but bond, equity and credit markets had a meltdown. The Fed was forced to reverse course in what became known as the "Powell Pivot". Some have dubbed Powell's recent hawkish rhetoric a second pivot, though it is too soon to call it that. Either way, in 2018 the Fed completely overestimated the economy's ability to handle higher rates and its overzealousness in pushing ahead with rate increases (and quantitative tightening) resulted in very poor investment returns all round in 2018. Though history never repeats precisely, the big risk for 2022 is a rerun of 2018.

Much like Ebenezer Scrooge, one can hope that the Fed learned its lesson after engaging in deep introspection during 2019 and reviewing its policy framework to focus not just on inflation, but also on ''broad-based and inclusive" employment. But hope is not, as they say, a strategy and we need to be prepared for all eventualities.

IN SUMMARY

Before we say goodbye to the year, we are therefore confronted with two broad ideas. Firstly, there are certainly risks on the horizon. There always are, but the start of a US rate hiking cycle is a particularly delicate moment since the entire global financial system needs to adjust in response. This adjustment can be smooth, or it can be violent. We will only know when we are there. Secondly, as much as we are mindful of risks and try to mitigate against these with sensible diversification, investing always involves some level of just putting your head down and getting on with it. There will be doomsayers, hopeless optimists, corrections, periods of volatility, and stretches of disappointing returns. But in the end, patience and perseverance are rewarded.

EQUITIES – GLOBAL

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
Global	MSCI World	US$	3 188.0	3.31%	2.77%	18.51%	21.26%
United States	S&P 500	US$	4 712.0	3.83%	3.17%	25.45%	28.46%
Europe	MSCI Europe	US$	2 030.0	3.05%	3.36%	10.33%	12.59%
Britain	FTSE 100	US$	9 677.0	2.65%	3.05%	9.60%	10.30%
Germany	DAX	US$	1 651.0	2.61%	1.41%	1.44%	8.55%
Japan	Nikkei 225	US$	250.8	0.94%	0.34%	-8.38%	-2.31%
Emerging Markets	MSCI Emerging Markets	US$	1 239.0	1.14%	2.23%	-4.03%	-1.27%
Brazil	MSCI Brazil	US$	1 469.0	3.31%	4.70%	-21.70%	-21.19%
China	MSCI China	US$	86.8	1.76%	0.44%	-19.92%	-17.66%
India	MSCI India	US$	833.1	0.97%	2.21%	23.41%	28.96%
South Africa	MSCI South Africa	US$	439.0	-0.68%	0.69%	-2.44%	1.15%

EQUITIES – SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Share (Capital Only)	All Share (Capital Index)	Rand	71 686.0	1.24%	1.72%	20.67%	20.92%
All Share	All Share (Total Return)	Rand	11 640.0	1.29%	1.87%	25.61%	25.95%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	28 481.7	-0.10%	1.36%	22.85%	24.29%
TOP 40/Large Caps	Top 40	Rand	10 566.0	1.72%	2.17%	25.16%	25.32%
Mid Caps	Mid Cap	Rand	18 862.0	-1.33%	0.63%	24.36%	26.81%
Small Companies	Small Cap	Rand	25 603.0	-1.30%	0.61%	49.11%	50.30%
Resources	Resource 20	Rand	5 178.4	2.18%	1.04%	26.72%	27.52%
Industrials	Industrial 25	Rand	19 483.0	1.36%	2.19%	23.76%	21.82%
Financials	Financial 15	Rand	9 171.0	1.10%	4.00%	21.52%	27.25%
Listed Property	SA Listed Property	Rand	1 617.2	0.24%	3.60%	31.48%	32.02%

FIXED INTEREST – GLOBAL

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
US Aggregate Bond Index	Bloomberg Barclays	US$	534.0	-0.17%	0.16%	-4.43%	-3.69%

Fixed Interest – South Africa

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	811.6	0.63%	1.30%	6.94%	8.63%
Government Bonds	BESA GOVI	Rand	801.1	0.62%	1.31%	6.82%	8.57%
Inflation Linked Bonds	BESA CILI	Rand	306.7	2.26%	2.45%	13.16%	11.87%
Cash	STEFI Composite	Rand	481.2	0.08%	0.11%	3.58%	3.80%

COMMODITIES

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
Brent Crude Oil	Brent Crude ICE	US$	74.4	6.50%	7.86%	43.12%	48.84%
Gold	Gold Spot	US$	1 783.0	0.00%	-0.56%	-5.86%	-2.78%
Platinum	Platinum Spot	US$	947.0	1.18%	-0.63%	-11.50%	-5.86%

CURRENCIES

Description	Index	Currency	Index Value	Week	Month-to-date	Year-to-date	1 Year
ZAR/Dollar	ZAR/USD	Rand	16.01	0.23%	-0.78%	-8.26%	-6.20%
ZAR/Pound	ZAR/GBP	Rand	21.20	0.38%	-0.33%	-5.28%	-5.80%
ZAR/Euro	ZAR/EUR	Rand	18.10	0.54%	-0.51%	-0.84%	0.76%
Dollar/Euro	USD/EUR	US$	1.13	0.00%	0.35%	8.14%	7.08%
Dollar/Pound	USD/GBP	US$	1.33	-0.26%	0.22%	3.23%	0.22%
Dollar/Yen	USD/JPY	US$	0.01	0.51%	0.20%	9.74%	8.80%

Source: I-Net, figures as at 10 December 2021

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