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Adviceworx

Investment *Outlook*

2022 is expected to be a year of several inflexion points. Covid-19 has been part of daily life now for nearly two years and most governments and citizens have reluctantly accepted that it is near impossible to eradicate the virus. Hopefully, this year Covid-19 evolves from being a pandemic to becoming endemic. However, a return to a pre-pandemic normal is not expected as some economic fundamentals are expected to shift this year. After being absent for several years, central banks will have to fight an old foe, inflation, which has steadily risen in response to pandemic-induced bottlenecks, labour market imbalances and rising energy costs. The tricky transition to greener energies could see more energy crunches and spikes in energy prices. Expect tighter monetary conditions at home and abroad.

2022 will also be a pivotal year for the global economy, as it transitions from an early cycle recovery to a mid-cycle expansion without the benefit of gargantuan fiscal stimulus. China, the world's second largest economy, is expected to slow this year weighed down by a slowing property market and its zero-Covid policy, which will make a full reopening of the economy difficult, if not risky. US-Sino relations are likely to become more strained as China becomes more authoritarian at home while internationally, questioning the effectiveness of Western-style democracy.

2022 will also be a busy year on the political front. Chinese President Xi-JinPing will become the first leader since President Mao Zedong to seek a third term, seeking to rid China of its capitalist excesses and exerting further control over the Communist Party and quashing any dissenting voices. The Democrats risk losing Congress in the US mid-terms, which means there is less scope to get things done in an already polarized and sclerotic political system. 2022 will be a politically noisy year for South Africa, with renewed power struggles focused on the ANC leadership and its internal factions in the run up to the ANC national elective conference.

International

From recovery to expansion

Following a year of economic recovery, albeit somewhat uneven given the pervasiveness of Covid-19 variants, the global economy is forecast to grow by a robust 4.9% in 2022, underpinned by pent-up demand, excess savings and increased mobility rates. New variants of the virus will continue to challenge economic growth but are not expected to derail it. This robust growth masks the fact that the global economy is still 2.3% smaller than it was prior the pandemic. While 2021 was the year for a recovery in the goods sector, the services sector remains more than 3% below its pre-crisis level. With a move towards a new normal and an increase in mobility rates, a rebound is expected in the services sector.

A reopening economy and massive fiscal stimulus are expected to have boosted US GDP growth to 5.7% in 2021. This year the economy is expected to grow by 3.7% underpinned by strong consumer consumption, inventory restocking by businesses and robust wage growth in response to tight wage markets. Unemployment is expected to fall back below 4% which will keep wage growth firm.

After a significant contraction of 6.3% in 2020, the Euro area rebounded in 2021, growing by an estimated 5.1%. Healthy private sector fundamentals and government policy which protected jobs should result in above trend growth of 4.6% this year. While supply chain disruptions and tensions in the gas market persist, these are not expected to derail growth. The Euro area should also expect to see inflation rise, which has been elusive for several years. Core inflation is expected to average 1.7% in 2022, however it is unlikely to prompt any action from the ECB, which will be cautious of repeating the mistakes it made in 2011 where it tightened policy too quickly, stifling economic recovery following the Global Financial Crisis.

China's zero-Covid policy could weigh on growth and exacerbate supply chain disruptions

China's zero-Covid policy, which has led to aggressive lockdowns to stop transmissions, could result in economic disruption and exacerbate supply chain disruptions. It also means that China's population has low levels of antibodies against various Covid variants, so reopening the economy could be risky. Chinese policy shift towards decarbonization, technology companies, education and a policy move towards more productive investment will create transitional pains and possibly more regulatory headwinds. Growth is likely to undershoot government's growth targets, coming in just below 5%, its lowest level in nearly three decades.

Economic divergence

Notwithstanding the expectation of solid global growth for 2022, economic challenges from the pandemic persist. Unequal access to vaccines and government support has exposed the fault lines laid bare by the pandemic. Low vaccination rates put additional stress on healthcare systems and is disruptive to labour market availability and productivity, resulting in inequalities in health and economic outcomes. This will drive an economic wedge between those countries that can move towards a new normal and those that will struggle with health and economic consequences of recurring infections. According to the World Economic Forum's Global Risk Report, advanced economies are expected to surpass their pre-pandemic growth path by 0.9% by 2024. However, developing economies (excluding China) where vaccination rates have been lower, digital adoption has been slower and incomes have fallen, will be 5.5% below pre-pandemic growth levels. Latin America and Sub-Saharan Africa are forecast to trail even further behind. Economic, political and technological inequality, together with income inequality, risk increasing polarization and an erosion of social cohesion. In an Executive Opinion Survey conducted by the World Economic Forum, an erosion of social cohesion was viewed as a top-10 threat in countries including Argentina, Mexico and South Africa.

Projected GDP growth

	Year over Year		
	2020	**2021**	**2022**
Global economy	-3.1%	5.8%	4.2%
Advanced economies			
United States	-3.4%	5.7%	3.7%
Euro Area	-6.3%	5.1%	4.6%
United Kingdom	-9.8%	6.9%	4.7%
Emerging economies			
China	2.3%	7.8%	4.9%
India	-7.3%	8.6%	9.0%
Brazil	-4.1%	4.5%	-0.5%
Russia	-3.0%	4.5%	2.7%
South Africa	-6.4%	5.2%	1.7%

Source: JP Morgan and SARB

South Africa

More of the same

South Africa enters 2022 on a better footing as the Omicron variant has been less severe than expected and the economy should fully reopen. This will be good for service orientated industries such as hospitality and tourism which are important sources of employment. Another positive outcome has been Fitch's upgrade in its outlook for South Africa from negative to stable following improved growth and fiscal metrics. Government should capitalize on this outcome by prioritizing policy certainty and engendering an investment friendly economic environment. Other focus areas for 2022 include stabilizing Eskom and expanding the role of independent power producers as insufficient electricity supply will continue to undermine the country's growth prospects.

Following a GDP growth rebound of approximately 5% in 2021, growth forecasts for 2022 range from 1.4% to 2%. By all counts, this growth is too low to address South Africa's frightening official unemployment rate of 34.9%. A policy change from centrist government-induced growth to private sector involvement is needed to ensure more sustainable and inclusive growth. Sadly, business confidence was sorely hurt post the July riots and has hurt investment plans. Fixed capital formation which increases the country's productive capacity through investment in infrastructure, property, plant and equipment, fell to a dismal 13.9% of GDP in 2021 and is expected to remain flat in 2022 in the absence of structural reforms to boost business confidence. South Africa is falling behind its emerging market peers where fixed capital formation is running closer to 20% of GDP.

The domestic economy will also have to navigate a tougher global environment in 2022 as US monetary policy is expected to tighten, which will put pressure on domestic interest rates. China, South Africa's largest export partner, is expected to grow more modestly this year which could see a softening in export demand. If domestic investment does pick up this year, this should see an increase in imports and a relative weakening of our terms-of trade and the current account moving back into a deficit of 0.6% of GDP.

The SARB has guided for a collective interest rate hike of 100bps in 2022 following an upward revision to inflation to 4.3% in 2022 (from 4.2%) and 4.6% in 2023 (from 4.5%). Global producer prices, food inflation as well as transportation inflation are likely to add upward pressure to inflation in the first half of 2022. Given weak demand and benign second-round inflation, interest rate increases should occur in 25bps increments instead of 50bps increments.

Despite calling for a consolidation of the fiscus, pressure will mount on Finance Minister Enoch Godongwana to increase social grants, extend financial support to ailing SOEs and increase civil servant wages. These all pose a risk to stabilizing South Africa's debt. On the positive side, government revenue is expected to be strong and to exceed FY21/22 budget estimates, which will help lower the fiscal deficit towards 6% of GDP from 6.6%.

President Cyril Ramaphosa faces a difficult year ahead. While he is expected to be re-elected for a second term as ANC president given his popularity among voters, 2022 will be a politically noisy year, with renewed power struggles focused on the ANC leadership and its internal factions. A victory for South Africans will be the prompt implementation of the key recommendations from the Zondo Commission. Numerous cases of violations of the Public Finance Management Act should be easy pickings for the National Prosecuting Authority.

Tactical Asset Allocations

Domestic asset classes

Domestic **Equity**

Slightly Underweight

Earnings

- Some of the strong tailwinds that underpinned the rebound in earnings last year are expected to moderate in 2022. Moderating global growth, quantitative tapering by the Fed, rising interest rates, monetary tightening in SA, moderating commodity prices and diminishing terms of trade suggest that earnings growth in SA should normalise in 2022.
- Uncertainty remains about the shape of the earnings recovery beyond 2021. Earnings had a strong recovery last year, up by over 165% off a very low base following a collapse in earnings in 2020. This year, JP Morgan expects the earnings of the JSE Capped Swix to increase by 7% in 2022. This is on the premise that SA resources will experience a negative year of earnings growth (-16.3%). However, financials and industrial earnings are expected to grow by 24.1% and 24.4% respectively.
- Over the past three months, we have seen notable negative earnings revisions in Basic Materials (Precious Metals and Industrial Metals) and Technology (Naspers & Prosus).
- Sectors with meaningful upward revisions include Forestry & Paper, General Financials and Health Care. Food producers, Personal Goods, Banks and Chemicals have also had positive earnings revisions.
- For a more enduring earnings growth cycle in the coming years, concrete policy action and follow-through by the government (energy, spectrum and SOE reforms) to improve business confidence and fixed capital investment is necessary.

Valuation

- South African equity remains attractive relative to its developed and emerging market peers.
- SA equity is cheap relative to its history – the 12-month forward P/E of 10.2x is trading at a 23% discount compared to its 10-year average of 13.2x.
- Stripping out Basic Materials, where earnings have probably peaked and P/Es have bottomed, SA equity is trading at fair value.

Asset allocation view

- Domestic equity is trading at reasonable valuations relative to history and is cheap relative to DM and EM peers.
- Risks to growth will remain due to slow household consumption, constrained business investment, limited energy supply and sluggish reform momentum.
- The uncertain outlook for earnings growth beyond this year underpins the slight underweight allocation to domestic equity.

Domestic **Listed Property**

Maximum Underweight

Fundamentals

- Net operating income remains under pressure as rentals revert to market levels, escalate at lower and more normalised rates and municipal and tenant incentive costs grow at excessive levels.
- Continued space consolidation, liquidations and an oversupply of office space will result in higher office vacancies across quality grades and regions. As tenants re-vacate up the quality curve at lower rentals, lower grade office space could become obsolete.
- Trading densities have improved in retail outlets. Super regional malls have had a rebound in activity, but community centres are the only segment above 2019 levels. Collections are strong and less relief for entertainment, restaurants and gyms are likely to unfold during 2022. Vacancies are expected to stabilise.
- Demand for storage will continue while interest rates are low and there are home upgrades, and offices transitions.

Valuation

- The sector is cheap and trades at a 17% discount to NAV.
- Yields are attractive at 7.2% but are priced at a 200-basis point premium to the South African 10-year government bond.

Asset allocation view

- Although much of the value destruction due to rental rebasing and lower escalations is behind us and vacancies are expected to either stabilise or trend downward, there are limited growth opportunities beyond relief unwind and dividends from offshore REIT partnerships. South African REITs are expected to resume dividends but are at lower levels than pre-Covid.
- Relative to domestic property, domestic bonds offer a better risk-adjusted yield.
- Remain maximum underweight local property.

Domestic **Fixed Income**

Overweight

Nominal bonds

- Compared to their long-term averages, nominal bonds remain attractive relative to cash, inflation and they are also cheap relative to emerging market peers.
- The steepness of the yield curve compared to peers suggests that there is a significant risk premium embedded in South African government bonds. The substantial risk premium reflects investor scepticism about SA's growth reforms and fiscal consolidation commitment. Investors also remain uneasy about the impact of global tapering on SA bond yields and the rand, although our yields more than adequately compensate investors for this uncertainty.
- Notwithstanding the fundamental risks, nominal bonds still do appear extremely attractive.

Inflation-linked bonds

- Relative to nominal bonds, inflation-linked bonds are only attractive in the very short-end of the curve (maturity buckets of less than 5 years).
- The inflation outlook is benign and in the absence of an inflation shock, investors are receiving better inflation compensation out of nominals at longer maturities.

Credit

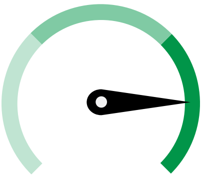
- The credit market remains depressed. High levels of credit risk and risk aversion have caused spreads to compress due to excess demand for shorter-term maturities in high-quality sectors.
- Valuations remain expensive and yields do not reflect implicit credit risk.

Asset allocation view

- Remain overweight with a preference for nominal government bonds.

International asset classes

International **Equity**



Overweight

Earnings

- Economic expansion and elevated inflation will prompt central banks to progressively unwind their unprecedented levels of liquidity (monetary accommodation). Although the global growth backdrop will likely remain supportive for stocks, expect greater volatility and more modest returns going forward.
- Strong corporate earnings will remain supportive of equities. The labour market, a key driver of consumer expenditure, is improving. Consumers have strong balance sheets and their spending habits will normalise. Corporate inventory levels are very low, requiring replenishment which will be a tailwind.
- Earnings for developed markets are expected to have increased by 52.2% in 2021 and reach more normalised levels of 7.2% in 2022 and 8.6% in 2023.
- US earnings are forecast to have expanded by 51.1% in 2021 and to normalise to 7.5% in 2022 and 10.3% in 2023. Earnings in the Eurozone are expected to have posted a strong recovery in 2021 of 70.3%. Earnings are expected to normalise, growing by 7.5% and 8.5% in 2022 and 2023 respectively.
- Emerging Market earnings are expected to have grown by 54.4% in 2021 and to normalise to 7.5% in 2022 and 10% in 2023.

Valuation

- Valuations ex-US still look attractive on a relative basis (Europe, Japan and Emerging Markets). However, relative to history, most regions trade above their long-term averages.

Asset allocation view

- Overall valuations are stretched (earnings are close to if not at the peak in the US), where much of the recovery has been priced in, leaving little room for disappointment
- Inflation risk has become more pronounced as higher inflation may persist for longer than expected. Global equities will get support from rising earnings, but higher bond yields could pose a headwind for already elevated valuations.
- An overweight position in international equity is maintained but some profit has been taken and placed in global cash awaiting further investment opportunity.

International **Listed Property**

Overweight

Fundamentals

- Global REIT fundamentals look strong. A price recovery in 2021 has resulted in REITs issuing equity and debt in nearly equal proportions, fuelling property acquisitions that should support future earnings growth.
- While consumers favour the convenience of online shopping, they have demonstrated appreciation for in-store shopping on select items which will likely drive the recovery of brick-and-mortar retail in 2022, while also supporting e-commerce and the continued long-term growth of industrial and logistic REITs.
- Employees have begun returning to the office. Companies are expected to utilise a hybrid model where the office remains a hub of business activity but with a flexible work-from-home policy for staff, requiring comparable amounts of floor space before the pandemic, but with less density on any given day. This should drive a stabilisation in occupancies.
- Accelerating leisure has seen hotels, restaurants, and entertainment improve, but those that cater to business travellers will likely see an accelerating recovery as 2022 progresses.
- Limited supply of residential property on the back of slowed construction following the 2008/9 housing crisis, as well a desire for more space, will continue to buoy rental and prices but capped by consumer affordability.

Valuation

- REIT yields of 3.2% are attractive relative to the US 10-year treasury bond yield of 1.79%. Dividends may increase on the back of improved operating performance.
- Global property is trading above its long-term valuation metrics and is looking expensive relative to history on a forward price to funds from operations (P/FFO) basis.

Asset allocation view

- Listed property is expected to outperform government bonds in 2022. Property yields should protect against sustained inflationary pressures due to built-in lease escalations and while rate hikes will lower property values, moderate loan-to-value ratios, high interest coverage ratios and improved term-to-debt maturities should provide some downside protection. A dynamic asset class with varying sub-sectors and regions provides diversification benefits in a balanced portfolio.
- Remain overweight.

International **Fixed Income**

Underweight

Fundamentals

- Fixed income markets are expected to be more volatile in 2022 as markets navigate incoming inflation data, the withdrawal of central bank support and the path of interest rates. Supply chain constraints, rising energy costs and wage inflation have fed into higher inflation. The risk is that inflation becomes stickier than initially hoped and that positive real rates may be needed to tame run-away inflation, which in turn could stifle economic growth.
- The Fed's headline inflation forecast for 2022 has been revised upwards from 2.2% to 2.6%. The Fed is expected to start tapering its bond purchasing programme and to end asset purchases by March.
- The European Central Bank (ECB) has lifted its inflation forecast to 3.2% in 2022 and is also expected to taper its Pandemic Emergency Purchase Programme by March.

Valuation

- USD cash and government bonds are expensive.
- Following a tightening in credit spreads last year, investment grade bonds were expensive. The risk this year is that spreads will widen again in response to rising inflation.
- High yield credit is relatively more attractive than investment grade fixed income from a valuation perspective and should benefit from robust economic growth.
- Emerging market bonds are more attractively priced relative to developed market bonds, but risks have increased given rising global rates and increased geopolitical risk (Latin America and Eastern Europe).

Asset allocation view

- Retain underweight position.

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Data sources

- Market returns: FactSet
- Earnings estimates: IBES, Thompson Reuters and JP Morgan
- Global growth forecast: JP Morgan and SARB