MAY 2022

Prosperity

Adviceworx Private Client Portfolios

Adviceworx

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Markets have been shaken this year by seemingly never-ending market moving events and concerns. The US Federal Reserve's hawkish policy shift in January was the first to catch investors' attention. This was promptly followed by Russia invading the Ukraine in February, while March saw a spike in anxiety levels due to inflation concerns. During April, ongoing lockdowns in China and the resultant economic impact occupied investors' minds. More recently, as the Fed looks to move more aggressively to tame inflation, markets have started pricing in the possibility of a recession, with many economists giving this outcome a greater than 50% probability. In summary, a lot has happened this year.

Given that these newsworthy events are compounded by the fact that global market valuations have de-rated significantly, it is hardly surprising that markets (specifically European and US markets) are in bearish territory. The most recent leg down was due to higher-than-expected and longer-than-expected inflation data in the US. The concern is that the Fed will act more aggressively than originally anticipated, increasing the likelihood of a US recession.

In the midst of all of this, it is important to note that global and US company earnings have held up well thus far, but given the economic uncertainty, we will be watching closely for any signs of earnings weakness in the second half of the year.

One of the few certainties in financial markets is that through the fullness of time, equity markets move higher. However, as we know (and are currently witnessing), this does not occur in a straight line. It is therefore vital that investors are well diversified, resilient and manage their asset allocation closely in line with their own unique circumstances and objectives. If this is in place, they should not be overly concerned about short-term market moves or what happened in one particular market. Importantly, as market participants with broader mandates start to capitulate; great opportunities will emerge for the bespoke, patient and long-term investor.

ECONOMIC UPDATE

Global economic activity was still reasonably strong in May. Despite this, concerns over a material global economic slowdown continue to build. Indeed, more and more commentators talk about the risk of a recession.

China might be in recession already due to its harsh COVID lockdowns. April data saw sharp contractions in retail sales and industrial production, while surveyed unemployed increased. As the lockdowns are lifted on a city-by-city basis, economic activity should rebound quite quickly. However, the temporary slowdown might worsen structural weaknesses in the economy such as excessive debt and overbuilding of residential property. While Beijing announced several stimulus measures including tax cuts and small interest rate reductions, these are unlikely to make much of a difference while the lockdowns persist. They are also limited in scope, unlike in previous cycles when authorities threw the proverbial kitchen sink at it trying to raise growth rates.

In Europe, the big recession risk is posed by the war on its eastern border. Not only are consumers and businesses already enduring a massive purchasing power shock due to energy price spikes, but the spectre of a hard stop in oil and particularly gas flows persists. If either side cuts the flow of Russian gas – the European Union has already proposed a ban on oil imports – it will take many European companies months to adjust, and activity could decline materially in the process. At the same time, the European Central Bank has turned hawkish, indicating that it will take interest rates back to zero by September and into positive territory thereafter.

In the US, it seems very strange to be talking about a recession since the economy has been booming. Until recently, the biggest problem has been a shortage of workers, not jobs. However, a slowdown is looming. Forward-looking measures point to slowing orders while inventories are starting to build. The red-hot housing market is cooling in the face of mortgage rates that have almost doubled over the past six months. And while consumer spending remained robust despite the decline in real incomes, it is because consumers are dipping into their savings and borrowing more. This is not sustainable.

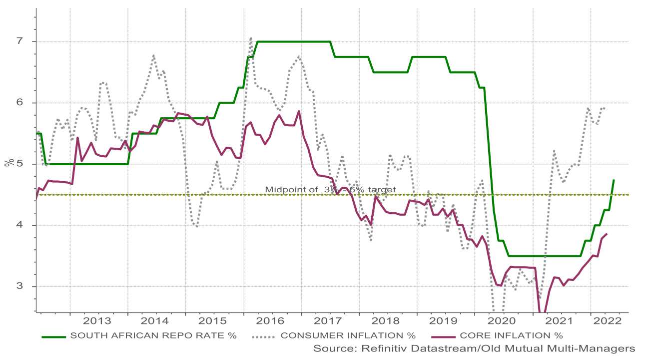
Crucially, inflation at 6% according to the Federal Reserve's preferred measure (4.9% excluding food and energy) is simply too high, even if it has likely peaked. Getting it down is the priority now, even if it hurts the economy. The Fed will keep applying monetary pressure until there is "clear and convincing evidence" (in the words of Chair Jerome Powell) that inflation is on the way down. At the same time, as monetary policy is turning the screws, fiscal policy has also tightened substantially as the budget deficit shrinks. A recession is by no means inevitable, but the risk of a material slowdown in economic activity has certainly increased.

Back home, South Africa's economic outlook has also weakened, but the country is in the fortunate position of still benefiting from high commodity prices, particularly coal. Indeed, the coal price has risen more than the oil price. Our big problem is that infrastructure bottlenecks mean we export a lower volume of coal than in past years. Moreover, the average consumer does not care about coal exports, they care about the fuel price. And the fuel price keeps going up, even with the government's decision to extend the fuel levy cut for another two months.

Inflation is still quite subdued by current global standards (consumer inflation was unchanged at 5.9% in April) but is nonetheless eating into consumers' purchasing power. The same is true for elevated food prices and as always, lower income households are the hardest hit.

However, core inflation, which excludes food and fuel prices, was 3.9% in April and is comfortably below the midpoint of the range. This means that the pass-through from higher fuel prices to core inflation remains low, indicative of companies' lack of pricing power, in contrast to the US and some other developed countries where companies have maintained very high margins.

The Reserve Bank's response has been to front-load some of its interest rate hikes. The May Monetary Policy Committee meeting resulted in a 50 basis point increase, in contrast to the usual 25 basis point increments.

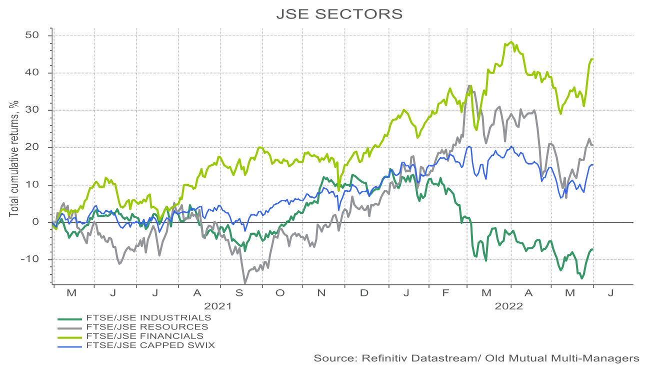


Since the inflation outlook has not drastically deteriorated, and the growth outlook is somewhat worse, it is reasonable to say that the MPC is more focused on global factors. With the Fed putting in 50 basis point hikes, the MPC cannot fall too far behind, especially since other emerging market central banks already started hiking aggressively last year. However, the repo rate is still likely to settle at a lower peak than the previous cycle..

MARKET UPDATE

During May, nearly all asset classes declined in the first half of the month and then bounced back during the last week. The themes for the month were rising interest rates, inflation, the ongoing Russia vs Ukraine saga and fears of a potential US recession.

In the US, the S&P 500 (+0.04%) and the Dow (+0.01) were up marginally over the month, while the NASDAQ declined by 2.1%. The UK's FTSE 100 ended May with a 0.8% gain. After three months, Shanghai and Beijing announced the easing of lockdown restrictions. This spiked a rally in Chinese stocks towards the end of the month, with the Hang Seng (+1.5%), the Shanghai Composite (+ 4.6%) and the Nikkei (+1.6%) all recording gains.



Locally, banking and insurance companies outperformed most sectors. The JSE All Share Index ended the month 0.5% lower. The Resource 10 Index (RESI 10) was a tad lower (-0.3%) and the Industrial 25 Index (INDI 25) was down 2.4% during the month. Towards the end of May, Brent crude oil rose above US$120 per barrel as EU leaders agreed on a partial ban on Russian oil imports. The gold price ended the month 3.1% lower. After the 8.3% decline In April, the rand clawed back 1.0% in May to close at R15.65/US$.

GLOBAL EQUITIES

WALT DISNEY

Media and entertainment giant, Walt Disney reported strong interim 2022 results that were supported by the re-opening of parks and resorts, a partial return to the box office and the resumption of live sports. The group's operations, however, continue to be impacted by closures and restrictions across some geographies. Film and television productions across the group have generally resumed, although there have been some disruptions within some regions. Theatre releases in the first half of the year increased, although certain markets continue to impose restrictions on theatre openings and capacity. Overall, revenue for the six months was up 29%, with income from continuing operations up 83%.

Given the recent disappointing subscriber numbers reported by streaming rival Netflix and its subsequent share price decline, investors were eagerly anticipating the results from Disney's streaming platforms. They were not disappointed as the numbers were impressive, with Disney+ adding 7.9 million subscribers during the first quarter. Across all of the group's direct-to-consumer platforms, Disney now has more than 205 million subscribers versus Netflix's 222 million. Considering Disney's late entry into the segment, this has been a phenomenal growth rate for the entertainment giant.

MEDTRONIC

Medtronic, the world's largest medical device manufacturer, reported full year 2022 results that, despite showing a fourth quarter acceleration across three of the four operating segments, was negatively impacted by increasing COVID-19 regulations in China and continued supply chain issues, which together held back revenue growth and impacted fourth quarter margins. Revenue was up 5.2% for the year, missing expectations by 1.1%, while operating income grew a strong 24%, just 2% below expectations. Emerging Markets remained the fastest growing geographical segment, with revenue up 13.6%, followed by the US (+3.9%) and non-US developed markets (+3.2%) over last year. The three largest segments, Neuroscience, Cardiovascular and Medical Surgical, all grew revenues between 5% - 6%, while Diabetes revenues were down 17%, highlighting continuing weakness for Medtronic in the treatment area. Despite the moderate revenue growth, both gross and operating margins expanded on well-managed input costs and lower restructuring charges. As a result, diluted earnings per share were up 25.6% from the prior year.

Along with the results announcement, management shared news on an upcoming joint-venture with DaVita. DaVita is a listed, leading kidney-services provider in the US. The firms announced intentions to form a new kidney-care company, inclusive of Medtronic's existing renal care solutions business, that will focus on developing a wide range of novel kidney care products and solutions, including home-based products to make dialysis treatments more accessible. Each company will own an equal equity stake and will also contribute an initial investment to fund the business. Renal care is a fast-growing treatment area with more than three million people globally living with kidney failure, a figure that is expected to double over the next ten years. The deal is expected to close towards the end of 2023.

LOCAL EQUITIES

VODACOM

Vodacom reported strong full year 2022 results despite levies in Tanzania weighing on performance. Revenue was up 5.8% (in constant currency) driven by new services, which include financial services (+14.4% on a normalised basis) and Internet of Things (IoT) (+32.1%). In aggregate, new services contributed 17.9% of group service revenue, which grew 4.6% on a normalised basis. The group's financial services business is the largest contributor to new services revenue although performance was dampened by mobile money transaction levies imposed in Tanzania. Adjusting for the levies, growth in financial services revenue would have been 23.4%. The launch of VodaPay in South Africa during 2021 complemented the group's financial services offering in the rest of Africa, with M-Pesa and Safaricom servicing other regions.

Group earnings increased 1.5%, negatively impacted by a once-off lease contract separation cost and increased technology spend. Group operating profit grew 5.4% on a normalised basis. The board declared a dividend of R4.30 per share, bringing the total dividends declared for the year to R8.50 (+3%).

NINETY ONE

Ninety One, formerly known as Investec Asset Management, reported their full year results for the period ended March 2022. The period under review was mainly characterised by strong markets and risk-on appetite from investors, with most of the market weakness occurring post year-end. Because of the buoyant markets, the group reported a 16% increase in average assets under management (AuM) from the prior year with closing AuM at £144bn. In addition to the market tailwind, the group reported strong net flows, reversing the trend of outflows that was experienced in the early part of the financial year. Net flows for the interim period were £5.0bn, versus an outflow of £0.3bn in 2021.

Revenue for the period rose by 10% to £664mn ahead of operating expenses that rose 9% to £434mn. Following good cost containment, and some contribution from performance fees, the group's adjusted operating margin increased by 0.5% to 34.7%. With a large portion of the group's expenses being variable, we expect the group's margins to remain resilient, above management's broad guidance of above 30%. With the group's strong cash generation and asset light balance sheet, the board declared a final dividend of 7.7p, which translates to an annual dividend of 14.6p, equating to a 76% pay-out ratio.

RICHEMONT

Richemont, the world's second largest luxury goods group, experienced continued robust trading conditions over the second half of their full year reporting period to end March 2022. Sales grew 46% (44% at constant exchange rates) while cost of sales growth was well managed to 35%, leading to 53% growth in gross profit. The strong sales result drove significant operating leverage that more than doubled operating profit and led the operating margin over 6% higher. Healthy, broad-based luxury demand was more than sufficient to offset headwinds from inflationary pressures and store closures related to COVID-19. All business segments, distribution channels and geographies saw strong sales growth on the prior year and pleasingly 35% up on pre-COVID sales. The group's renewed focus on direct-to-consumer engagement and the resumption of in-person events contributed to 76% of sales generated through retail and online retail channels, which also benefitted margin expansion. The supportive environment and strong operating result led earnings per share 57% higher to €3.61 per share. The board proposed a dividend of CHF 2.25 per share, up 13% on last year as well as an additional special dividend of CHF 1.00 per share.

Despite the strong performance, Richemont shares traded down by more than 10% on the release of the results. This follows sustained price weakness since the start of the year owing to the ongoing, severe COVID-19 restrictions instituted across major Chinese cities. Additionally, weakening global growth projections due to the Ukraine/Russia conflict have filtered into analyst expectations for global luxury goods. Richemont and its peers' share prices are, on average, down 20% on a year-to-date basis, leaving many at forward price/earnings ratio lows last seen over five years ago (excluding the onset of the pandemic). Specific to Richemont, a delay with the restructuring of YOOX-NET-A-PORTER (YNAP) into a neutral online platform also disappointed the market and added to negative sentiment. Luxury goods companies are typically defensive investments owing to the inherent value of the products they sell and the relative resilience of their target market. Following strong trading conditions over the past 12 months, Richemont maintain a cash-heavy, de-levered balance sheet, which should cushion the group against the volatile economic environment underway.

BYTES GROUP

The Bytes Technology Group, one of the UK's leading software and security specialists, reported strong full year 2022 results building on the impressive interim earnings reported six months ago. In line with a recent trading update, the group's results exceeded management's previous guidance. Gross invoiced income, a metric that best reflects sales growth in the business, rose 26.1%, driven by all business areas (i.e. software, hardware and services). Corporate client demand (+14%) remained strong since recovering from the pandemic-induced slowdown a year ago while the public sector business continued to grow faster at 36% year-on-year. Because of the once-off listing costs incurred in the previous year, operating profit for the current year was up 57%. Excluding these once-off costs, adjusted operating profit rose 23.6%.

As further demonstration of the continuing growth opportunities, Bytes is currently seeing management increased headcount by 13% during the period. In addition to the final dividend of 4.2 pence, the board proposed a special dividend of 6.2 pence. After adding the interim dividend, this bring Bytes' full year payout ratio to 80% of adjusted earnings per share, which is well ahead of the group's stated policy of returning between 40% - 50% to shareholders annually by way of dividends.

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