GLOBAL PERSPECTIVES

NOVEMBER 2022

THE ART AND SCIENCE OF NAVIGATING TOMORROW

Keep your eye on the prize

Global markets: Lessons from half a century ago

Preparing for an unpredictable 2023

De-risk on autopilot during the turbulence

It's all relative (to liabilities)

Resilient SA Inc is not the worst place to hide

The ugly duckling asset class fluffs up its feathers

There is light at the end of the tunnel

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Keep your eye on the prize

DUZI NDLOVU
Chief Executive Officer

“While it is certainly true that no one can predict the future, it is also true that we can shape our current reality.”

— DUZI NDLOVU

When things look uncertain, people look for any clue that offers a glimpse into what the future holds. These days there’s an entire profession dedicated to understanding the future, and futurists around every corner will happily talk to you about which jobs will be redundant in 50 years and how artificial intelligence will reshape (even more) our lives and careers.

The good futurists do this by focusing on signals, mega-trends and patterns, by looking back and learning from history, by taking a systems view of the world, and by adding a touch of psychology to help understand often unpredictable human behaviour.

In short, they combine art and science to navigate tomorrow. Something fund managers and wealth planners have been doing for years.

While it is certainly true that no one can predict the future, it is also true that we can shape our current reality. As the leader of India’s independence movement, Mahatma Gandhi, once observed: “The future depends on what we do in the present.”

Right now the world can seem like a daunting place. Recession fears are swirling, inflation is on the rise and, with a few exceptions, countries are embarking on cycles of interest rate hikes. In our world, this heightens the focus on minimising the volatility of liabilities and finding ways to de-risk investing. We’ve included articles on both of these subjects in this issue, alongside a pragmatic overview of what 2023 has in store for us. Jarred Sullivan’s contribution reiterates our promise to work tirelessly to preserve the invested capital of all our clients, particularly at this challenging time. It’s a promise we take seriously at Ashburton Investments, and one I echo here.

While our CIO’s contribution to this issue of Global Perspectives reaches back in time to draw stark parallels between our evolving global reality and that of the 1970s – from stagflation to inflation and high oil prices - I take heart that in compiling this bumper edition, two articles were submitted with similar working headlines. Both referenced a ‘light at the end of the tunnel’.

“The secret right now - as any good portfolio manager will tell you – is to prepare the ground in the present to nurture new opportunities and growth in the future.”

One article related to energy reforms in South Africa and the other to the prognosis for the listed property asset class. These are the green shoots which futurists watch for, the indications that something is shifting in the right direction. At a time when bad news seems to dominate, it’s comforting to know that there are still positives out there; and that they are firmly on our radar.

For South Africans, jaded after a year of load-shedding, persistent unemployment, crumbling infrastructure and political manoeuvring, there is also hope in Daniel Masvosvere’s observation that the country’s stock market has “been a picture of relative resilience”. Albert Botha and Tlhoni Komako also make mention of how well the rand has held up compared to other currencies during this crisis period.

Make no mistake, the entire world is facing economic fallouts and unpredictability currently. Some, like the United Kingdom, are exacerbating the impact of this global wave with damage of their own making, while others are just trying to hold on. The secret right now - as any good portfolio manager will tell you – is to prepare the ground in the present to nurture new opportunities and growth in the future. So, as tempting as it is to play futurist with your investment portfolio, keep your focus firmly on the present but your eye on the prize.

Global markets: Lessons from half a century ago

PATRICE RASSOU
Chief Investment Officer

Acclaimed American writer Mark Twain famously observed that 'history doesn't repeat itself, but it does rhyme'. If you pay attention to those remnants from the past, they can provide some interesting insights.

The US experienced stagflation in 1974-75 as the economy went backwards and inflation remained persistently high.

"US consumer sentiment indicators are back to depths last seen in the late 1970s."

Applying Twain's observation to today's complex array of market challenges, we decided to look back to the 1970s – a time of stagflation, weak growth, and high oil prices - to see what economic lessons we can glean from the past to help us better navigate tomorrow.

RECORD MARKET DECLINES

The first half of 2022 saw the largest absolute decline in asset prices in history, with global bonds and equities collectively losing US$31 trillion in value and cryptocurrencies shedding US$1.5 trillion. Compare this to the global financial crisis in 2008 where US$7 trillion was wiped off the value of global bonds and equities.

The Standard and Poor's 500 (S&P 500) entered a bear market – a sustained, market-wide downturn of at least 20% – with its worst half since 1970, losing 21%, while the Dow Jones Industrial Average also posted its worst half since 1962. Global bonds also had their worst start since 1865, with the previous record decline occurring after the First World War.

United States (US) government bonds were down 10% and US investment grade bonds lost 11%, their worst performance on record.

The star performer of the previous year, the Nasdaq was down by approximately 30% – after gaining 27% in 2021 – while global equities declined by more than 20% in US dollar terms. The reasons for the change in sentiment can be largely attributed to the change in stance by global central banks and the war between Russia and Ukraine. The war has pushed up inflation around the world, creating a vicious cycle of interest rate hikes as central banks scramble to tame inflationary impulses, just as global growth slows.

THE IMPACT OF OIL

US consumer sentiment indicators are back to depths last seen in the late 1970s. This is despite unemployment in the US remaining at lows of around 3.6% with the number of job openings remaining stubbornly high – a consequence of the 'great resignation'. The reference to the 1970s is, therefore, apt given that the era was characterised by stagflation – a unique period during which unemployment and inflation are high but economic growth stalls. Stagflation was, in turn, driven in part by two severe oil shocks.

At the time of writing, US consumers were paying more than US$5 per litre at the pump (and, here in South Africa, the figure was above R25 per litre). Today, the erosion of spending power caused by rampant inflation has become the main driver of negative consumer sentiment.

REWIND HALF A CENTURY

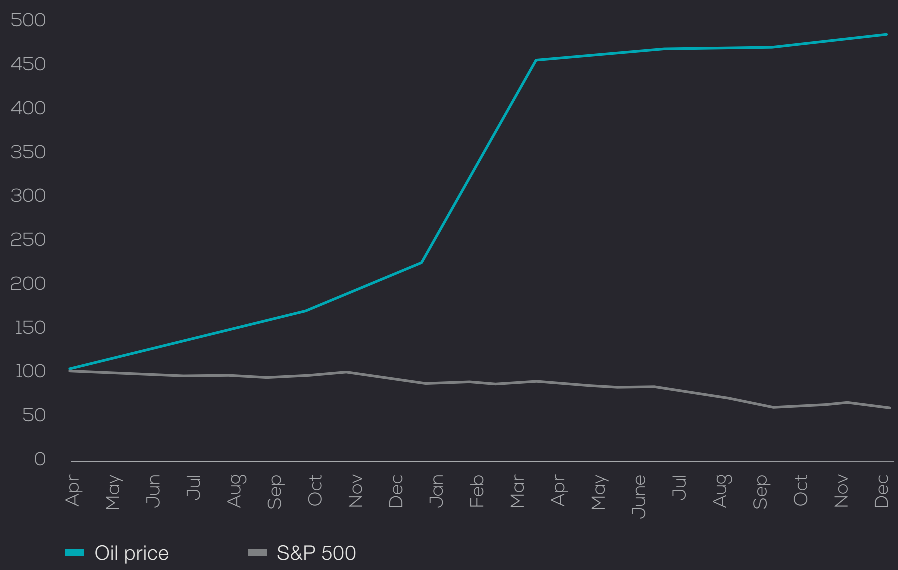
The 1970s saw a shift in power to the Organisation of Petroleum Exporting Countries (OPEC), from the previous cartel of seven oil producers. Over time, the five founding members of OPEC (Iran, Iraq, Kuwait, Saudi Arabia and Venezuela) were able to demand a bigger share of the price from the foreign companies to whom they had granted concessions. Rising demand for oil and constrained supply from the US allowed oil-producing countries to push up oil prices and tax the foreign companies exploiting their oil fields.

The surprise attack on Israel by Egypt and Syria on 9 October 1973 (the Jewish holy day of Yom Kippur), followed by aerial attacks by the Israelis on Syrian export terminals, led to a sudden disruption in the oil supply. To punish Israel's Western allies, OPEC decided to lift the oil price by 70% to US$5 per barrel and cut production to pressure Israeli forces to depart from territory they had seized after the 1967 war. The Saudis also banned all oil exports to the US due to its support for Israel. With the embargo in place, OPEC pushed prices up fourfold to US$12/barrel. As Figure 2 shows, there was more than a fourfold increase in oil prices in 1973-74 and a halving of the S&P 500.

FIGURE 1: THE RISE IN OIL PRICES COMPARED WITH THE S&P 500 (BOTH BASED AT 100 AT THE BEGINNING OF 2022)

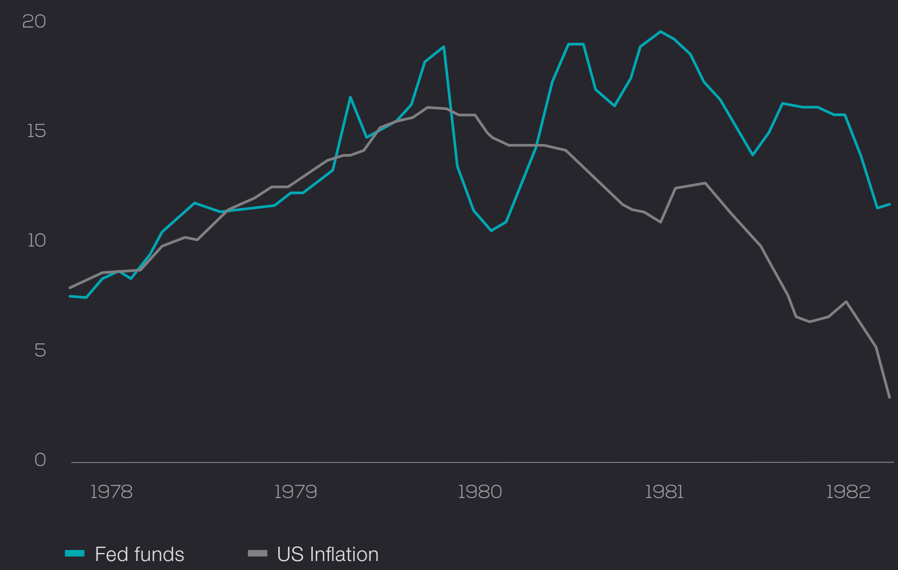
Source: Bloomberg

FIGURE 2: THE OIL PRICE COMPARED WITH THE S&P 500 IN 1973-74



Source: Bloomberg

FIGURE 3: THE FEDERAL FUNDS RATE AND US INFLATION BETWEEN 1978 AND 1982

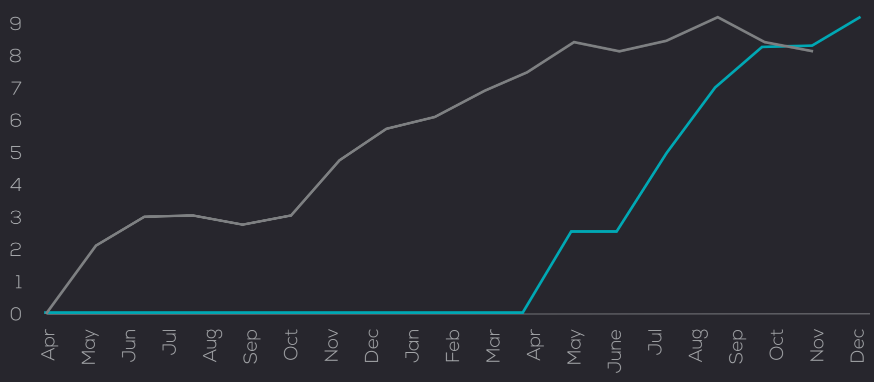


Source: Bloomberg

Given the current approach by some European countries, and the United Kingdom (UK), to use price controls to shield households from the spike in energy prices, it is interesting to reflect on the effectiveness of the price control measures imposed by the US administration in the 1970s. These measures backfired for the Americans as the price caps discouraged US oil production. They also led to shortages at the pump as the artificially lower prices only served to stimulate consumption.

The US Federal Reserve (Fed), under Arthur Burns, was reluctant to fight cost-push inflation by using monetary policy. The US experienced stagflation in 1974-75 as the economy went backwards and inflation remained persistently high. The S&P 500 also halved over the 1973-74 period. With inflation breaching double-digit levels in 1979, then US President Jimmy Carter appointed the hawkish Paul Volcker as Fed governor. Volcker led the war on inflation by hiking rates from 7% to 19% and driving inflation down from 13% to 4% in 1982 (see Figure 3). This move, however, came at a great cost, with unemployment rising to 11% and the US plunging into a prolonged recession in 1982. The S&P 500 fell by a third over the 1981-82 period.

FIGURE 4. THE FEDERAL FUNDS RATE AND US INFLATION (2021-2022)



Source: Bloomberg

CENTRAL BANK HIKING CYCLE

In moves reminiscent of the 1980s, the Fed unleashed a jumbo rate hike of 75 basis points in June 2022 – the highest rate hike since 1994 – to combat rampant US inflation, which is at 40-year highs. This was followed by two 75 basis points hikes in July and September. With inflation showing no sign of retreating, the expected Fed pivot to a softer stance at the beginning of 2023 is now a remote possibility with another 125-150 basis points of hikes expected.

Current Fed chairman, Jerome Powell, is now on track to go into the history books as the 'Volcker of our times' by fighting inflation at the cost of jobs and economic growth. The one difference is that the US economy is now a lot more leveraged than it was in the 1970s and a sharp increase in real rates will have a severe impact both on corporates and on households (see Figure 4).

If the 1970s are anything to go by, there is a high chance that the Fed will now risk plunging the economy into recession to wring out inflation. With the S&P down just over 20% year-to-date and corporate earnings likely to come under pressure, our multi-asset portfolios remain cautiously positioned.

This is especially prudent in light of the grim scenario that played out half a century ago, which provides a glimpse into what could yet unfold.

Back in 1848, Austrian aristocrat Klemens Wenzel Fürst von Metternich commented that: "When France sneezes, the whole of Europe catches a cold." Today, this observation is frequently applied to the US economy with the codicil that "the whole world is likely to catch a cold".

"With inflation showing no sign of retreating, the expected Fed pivot to a softer stance at the beginning of 2023 is now a remote possibility with another 125-150 basis points of hikes expected"

Preparing for an unpredictable 2023

JARRED SULLIVAN
Global Multi Asset Investment Strategist

As investors near the end of one of the most turbulent years in history, we reflect on the rollercoaster that was 2022 and delve into our expectations for financial markets heading into 2023.

The developed world's housing market is displaying signs of a slowdown, particularly if one looks at the UK and US mortgage approval and application data.

Given the persistent positive correlation between stocks and bonds, we believe raising cash is key at this point in time.

Bonds and equities registered poor returns in 2022, providing very little diversification benefit amid a highly uncertain investing environment.

The Russia-Ukraine war, a higher-than-anticipated global inflation trajectory, a stark shift in monetary policy communication, China lockdowns and slowing global economic data are among the primary reasons for the unprecedented operating environment.

STEMMING THE TIDE OF INFLATION

At this juncture, investors' focus is almost entirely on the United States (US) Federal Reserve's (Fed's) monetary policy outlook to determine how swiftly the world's largest central bank can quell the inflation trajectory. The resultant impact on economic growth and company earnings will likely determine the direction of asset classes in the future.

At the September Federal Open Market Committee (FOMC) meeting, the latest projection material was released. Personal consumption expenditure inflation forecasts were raised yet again throughout the forecast horizon and are projected to come in at 5.4% this year as opposed to 5.2% previously. Gross domestic product (GDP) estimates were lowered to just 0.2% this year from 1.7% previously. Most importantly, however, FOMC members lifted their dot plot projections for 2023 – their key short-term interest rate projections. This is despite the federal funds futures market pricing in interest rate cuts next year amid concerns over economic growth transitioning to a below-trend state.

These factors will likely make it difficult to generate returns in both equities and bonds, with the former already enduring a meaningful de-rating year-to-date – i.e., investors want to pay less for stocks per unit of earnings. Meanwhile, the latter has been at the mercy of the Fed lifting the global cost of capital, resulting in an unprecedented global repricing in government bond yields.

SUPPRESSED ECONOMIC ACTIVITY?

Our primary concern for next year is whether the resilience of company earnings can be extrapolated into the future. We believe this may prove difficult as fiscal and monetary policy, particularly in the US, will likely be on a restrictive path. In particular, the lagged effect of tightening monetary policy actions will likely begin to filter through to changes in consumer behaviour. Higher borrowing costs for both businesses and consumers will likely suppress economic activity, particularly in discretionary-related areas, as economic agents look to rein in expenditure to tighten their balance sheets and income statements.

According to the latest data on hand, US real average hourly earnings are sitting at -2.8% year-on-year as at end-August 2022. This registers as one of the lowest readings on record as inflation continues to erode consumers' purchasing power. Similarly, savings rates have plunged to just 3.5% as at the end of August 2022 – levels comparable with the 2008 global financial crisis – as consumers continue to tap into reserves to plug the income deficit. Additionally, households are utilising various credit instruments to prop up short-term expenditure, particularly credit card debt which is currently reaching all-time highs.

These dynamics, combined with a rapid withdrawal of liquidity, are certainly not sustainable and point towards an increasing probability of a hard landing in the global economy as we head into the new year. In the absence of supply-side reform by the US government, particularly in the energy sector, tempering economic demand will likely be the only way to bring inflation back towards the Fed's desired target of 2%.

HOUSING MARKET SLOWDOWN

The developed world's housing market is displaying signs of a slowdown, particularly if one looks at the United Kingdom (UK) and US mortgage approval and application data. However, it will take time to filter through to a meaningful moderation in housing prices. This will also be particularly important in the policy context of the US Fed, given that the housing market accounts for roughly a third of the Consumer Price Index (CPI) basket. However, Fed chairman Jerome Powell did acknowledge that activity has been subdued of late and has articulated that active selling of mortgage-backed securities is unlikely in the near future.

"Higher borrowing costs for both businesses and consumers will likely suppress economic activity, particularly in discretionary-related areas, as economic agents look to rein in expenditure to tighten their balance sheets and income statements."

“Given the persistent positive correlation between stocks and bonds, we believe raising cash is key at this point in time.”

HAMPERED GROWTH EXPECTATIONS

While the Eurozone Central Bank and the Bank of England intend to lift interest rates much further to tame inflation, the Bank of Japan (BoJ) remains on a divergent path. The BoJ’s reaffirmation of its commitment to accommodative monetary policy has put enormous pressure on the Japanese yen. A supply shock in natural gas and soft commodities markets – spurred on by the war between Russia and Ukraine – has severely hampered growth expectations, particularly in the UK and Europe. Consequently, corporate margins and household income statements in these regions will most likely be negatively impacted.

On the emerging market front, China continues to display mixed signals by easing on the monetary policy side, amidst well-contained inflation levels, while lockdowns continue to prevent sustainable recovery in economic growth. At this stage, we remain cautious, although valuations are looking cheap, and we expect opportunities to emerge in the coming months.

LOWERING RISK

Overall, we believe lowering the equity beta in the Ashburton Global Multi Asset Fund range has been the appropriate response to the current operating environment. This is particularly true as we head into a new year where, currently, we believe that economic growth and company earnings expectations are overly optimistic. We prefer sectors with less earnings cyclicality that are therefore less vulnerable to sporadic changes in the business cycle. We also have a strong US dollar bias which tends to benefit from both tightening global financial conditions and risk-off events – when traders and investors reduce their exposure to risks. The countercyclical nature of the greenback counteracts economic fluctuations, therefore offering better risk-adjusted returns relative to other asset classes in times of heightened uncertainty in the global economy. At this juncture, we prefer to take less risk.

On the fixed income side, we maintain our underweight duration position amid tightening monetary policy dynamics due to elevated inflation levels. However, once the peak hawkishness of the Fed has been sufficiently priced in by market participants, and inflation is firmly on a downward trajectory, we will be looking to take a more explicit position on the long end of the curve. This will be to reflect a deterioration in growth dynamics that will begin to overshadow inflation fears.

Given the persistent positive correlation between stocks and bonds, we believe raising cash is key at this point in time. Year-to-date, we are pleased to remain in the first quartile of performance within the Morningstar categories for our USD Global Growth and Balanced Funds. As always, we will endeavour to preserve the invested capital of our clients during these turbulent times.

De-risk on autopilot during the turbulence

ALBERT BOTHA
Head of Fixed Income

TLHONI KOMAKO
Portfolio Manager

In an environment where financial markets have been volatile, where should investors place their money? For many, Ashburton Investments' liquidity strategies are the answer.

With so many uncertainties, and given the pressure on risky assets, liquidity has been a primary focus for investors of late; more particularly now that rates are starting to rise

The current financial market environment has seen some of the biggest drawdowns in fixed income assets in decades. The Bloomberg Global Bond Aggregate Index (the world's largest fixed income index) is a measure of global investment grade debt from 28 local currency markets.

Year to date the index is down 18.7%. Previously, the poorest performances by this index were -4.2% in 2021 and -4.1% in 1999, making the current year its worst performance to date - more than doubling the previous two record-low drawdowns combined.

Turning to the United States (US), US Treasury bonds have returned -12.41% year-to-date and continue to be volatile, with the US 10-year trading at over 4% in September and October. The elevated inflation has meant that real yields remain high (year-to-end September US 10-year real yields were up 272 basis points), but looking at inflation expectations, breakeven yields have fallen from the peak of 4.93% in March to 2.01% at the end of September as the US Federal Reserve hiked by 3% year-to-date. This has raised concerns about central banks hiking the global economy into a recession to pull inflation down to within the target range.

THE EMERGING MARKET SITUATION

Within emerging markets, the Bloomberg Emerging Markets Hard Currency Aggregate Bond Index is down 19.38% year-to-end date with more than US$70 billion in emerging market bond outflows, compared to the US$50 billion in inflows seen last year.

The South African market has been echoing global trends, with the JSE All Bond Total Return Index down 1.34% year-to-date. The South African five-year credit default swap (CDS) is up at 345 basis points (bps) from below 200 bps in 2021. Looking at the currency, the rand has depreciated by R2.15 to the US dollar on the back of a strong greenback. Although the rand has remained under pressure, it has held up remarkably well compared to other currencies considering it is one of the most volatile currencies in the world with a tendency to depreciate during times of crises.

STRATEGIES FOR ADDRESSING THE LIQUIDITY ISSUE

With so many uncertainties, and given the pressure on risky assets, liquidity has been a primary focus for investors of late; more particularly now that rates are starting to rise.

We are increasingly being approached by investors or existing clients looking for defensive products to add some level of protection in the current market environment. Many find the right fit in Ashburton Investments' range of liquidity strategies.

All the funds below are designed to protect capital and provide liquidity, both in the current turbulent environment and during normal economic functioning. They are low risk, highly liquid and provide competitive returns in their respective Association for Savings and Investment South Africa fund categories.

ASHBURTON MONEY MARKET FUND

Investors are attracted to the Ashburton Money Market Fund as it provides competitive interest rates and aims to achieve returns in excess of call rates (the return target is STeFI three-month negotiable certificate of deposit + 0.5%). The fund provides regular income distributions, and capital preservation and has four payment runs to cover immediate liquidity on a same day (T+0) basis. Clients tend to invest in this fund to de-risk from volatile asset classes. The fund is run extremely conservatively with no corporate credit risk and invests solely in premier bank assets and short-term government Treasury bills. This is in addition to the maximum and average term limits of 13 months and 120 days respectively. The Ashburton Money Market Fund is our most conservative investment offering with a high degree of safety backed by the Global Credit Rating Company (GCR) credit rating of AA+(ZA)(f).

ASHBURTON CORE PLUS INCOME FUND (MONEY MARKET WITH ADDED TERM)

This recently launched fund is very similar to the Ashburton Money Market Fund, with two key differences. The fund allows for longer-term instruments and liquidity moves from the same day to the next day (T+1). The portfolio has a higher return target of STeFI Composite + 0.5%, which is done by sourcing additional yield from longer dated assets. The portfolio is permitted to hold instruments issued by the South African government and senior bank issued/guaranteed paper while corporate debt is not allowed. As with the Ashburton Money Market Fund, the Ashburton Core Plus Income Fund is also able to buy assets from foreign banks that have a local branch. The fund is also rated by GCR and holds an AA(ZA)(f) rating.

"With so many uncertainties, and given the pressure on risky assets, liquidity has been a primary focus for investors of late; more particularly now that rates are starting to rise."

> “A client has the freedom to choose and change their portfolio construction as their needs change.”

ASHBURTON STABLE INCOME FUND (CORE WITH CORPORATE CREDIT)

The Ashburton Stable Income Fund is the largest of the portfolios and was created with a slightly longer- term investment in mind. This fund is suited for investors looking for a short- to medium-term parking place for cash (three months plus) and it has a higher return target than the other two funds of STeFI Composite + 1.0%. The fund also provides liquidity on a T+1 basis. The portfolio is constructed using only instruments that have a duration of 0.25 or less, resulting in far less volatility than more aggressively mandated portfolios. As a result, the probability of long-term capital loss is extremely low. The fund is actively managed and designed to invest in income-generating instruments with a longer maturity than that of a traditional money market fund. The investment objective of the portfolio is to maximise the current level of income while maintaining capital stability and liquidity. The fund is allowed to hold corporate credit and will vary this exposure between 30% and 50% of assets under management depending on pricing, availability and the current credit outlook. GCR has rated this portfolio as AA(ZA)(f).

These funds are all regulated under Board Notice 90 (BN90) of the Collective Investment Schemes Control Act 45 of 2002 and are Regulation 28 compliant. We believe a combination of these funds can be used to meet any investor need within the low-risk liquidity space. An investor has the freedom to choose and change their portfolio construction as their needs change - selecting one fund or diversifying between all three, without friction or transaction costs. The end result is an investment that is safe, secure and liquid at all times.

It's all relative (to liabilities)

SYDNEY MATLADI
Portfolio Manager

Relativity and predictability have a place in navigating financial market fluctuations. But never forget the words of physicist Leonard Susskind that 'unforeseen surprises are the rule of science, not the exception. Remember: stuff happens.'

Focus needs to shift away from traditional asset allocation approaches towards those that are more liability driven.

As investors tackle global recession fears as well as lingering inflation, Ashburton Investments can help plans maintain their desired objectives of meeting their liabilities when they become due.

Commonality of activities has evolved to the point where we all have time and money in common. This commonality has ensured that financial market participants engage in activities that give to some and take from others.

Some market cycles can lead to symmetrical effects, while others lead to asymmetrical effects. It's the asymmetry that worries financial market participants.

Recession fears are a sign of asymmetrical behaviour in the markets. And, in a more global environment, this asymmetry tends to be inflated. As we saw with the Covid-19 pandemic, globalisation can be helpful, but it can also create chaos.

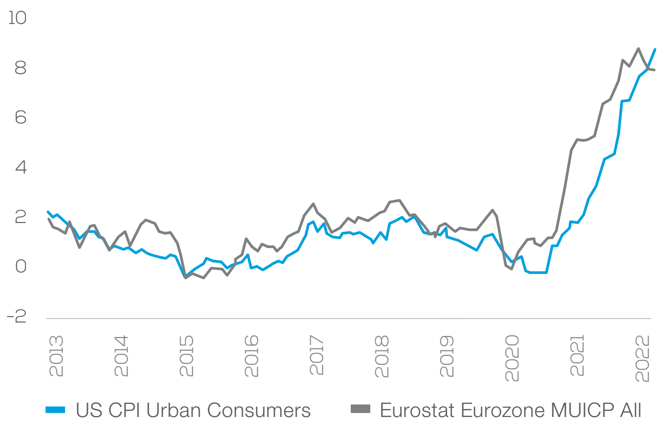
RECESSION CONCERNS

Currently, recession fears in the United States (US) have spilt into other parts of the world, both developed nations and emerging markets. As evidenced by recent market activity and performance, the asymmetrical nature of recessions is undeniable. The war between Russia and Ukraine has impacted various markets differently, with some feeling the lack of resource supply more than others. Nonetheless, we must all still worry about time and money. Each consumer and saver worry about 'the enough' at their disposal: Is there enough time to build up? Or is the money they have sufficient to live comfortably?

Such concerns are naturally linked to questions of inflation. Not long ago, market commentators were debating the nature of inflation. Some arguments were that it's transitory while others were that it's enduring. However, if you fast forward to the present, there really is no more debate. Rather there is agreement that central banks are fighting to contain inflation as it continues to trend higher (see Figures 1 and 2).

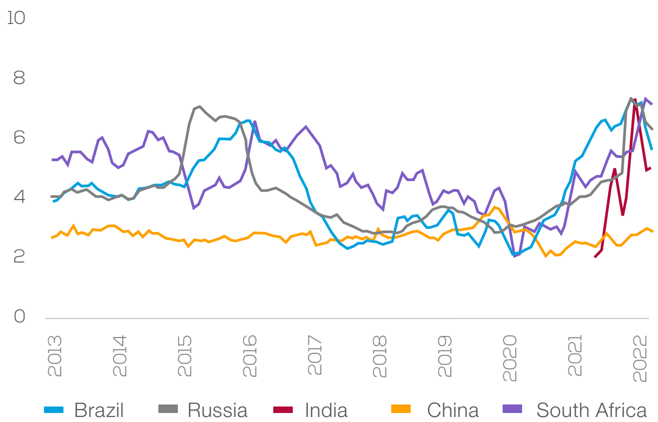
The world is wrestling with the risk of underinvestment because uncontrolled inflation will lead to the erosion of monetary resources. Here, the real return or value of investments will be very low and, in most instances, negative. To play catch-up will be a daunting task which is out of reach for many investors. The world is wrestling with the risk of underinvestment because uncontrolled inflation will lead to the erosion of monetary resources. Here, the real return or value of investments will be very low and, in most instances, negative. To play catch-up will be a daunting task which is out of reach for many investors.

FIGURE 1: G-10 YOY CPI



Source: Bloomberg

FIGURE 2: BRICS YOY CPI



Source: Bloomberg

* See China Common Prosperity policy.

“Recession fears in the United States have spilt into other parts of the world; both developed nations and emerging markets.”

AND THEN WE WENT HIKING...

The world now collectively agrees that the inflation call was all wrong. Unfortunately, the nature of globalisation means that those who arrived late to this realisation are left playing catch up. At the time of writing, the US Federal Reserve (Fed) had already delivered three consecutive 75-basis-point rate hikes. Combined, the central banks of the 11 member countries of the Group of 10 (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) had delivered 1 965bps of hikes. Those who have refused to do more, like Japan, were being punished to such an extent that it necessitated the intervention of authorities to protect the currency.

The point is that we can no longer rely on cheap liquidity, and when liquidity becomes expensive, markets tend to gyrate. We then witness a flight to quality, leading to a painful bear market which is characterised by a prolonged decline in prices. The figures below show how the markets have suffered year-to-date because of the hiking activity and the recession fears. The performance of the indices reflects behaviour normally observed in a bear market – namely a lack of or low confidence in financial markets, as well as pessimistic attitudes towards the future, which leads to persistent asset sales, as illustrated in the figures below (see Figures 3 and 4).

FIGURE 3: S&P 500 INDEX

Source: Bloomberg

FIGURE 4: NASDAQ COMPOSITE INDEX

Source: Bloomberg

THOU SHOULD NOT DEVIATE FROM OBLIGATIONS

Traditional asset allocation has always placed emphasis on what happens to an investor's assets. However, when one has obligations that need to be met, it's important that they pay attention to these throughout market evolutions. For institutional investors like pension funds and insurers with future liabilities that must be met, this perspective becomes relative.

Traditional asset allocation can lead to devastating effects on the investor's obligations when markets turn bearish, leading to unwarranted balance sheet volatility. Predictability is important where liabilities are concerned. Inflation can be a big enemy for defined benefit pension obligations. Preserving the purchasing power of benefits is important for sponsors. To do this, focus needs to shift away from traditional asset allocation approaches towards those that are more liability driven.

Here, liability-driven investing (LDI) plays a major role in helping investors minimise the volatility of their liabilities. LDI as an investment approach focuses on managing the risks that affect liabilities, which are interest rate and inflation risks.

When implementing an LDI strategy, the focus shifts from measuring risk using standard deviation to using surplus volatility. The aim is to find a balance between growth and risk, i.e. surplus volatility. Due to the limiting impact of inflation on plan liabilities, hedging these through inflation-linked instruments while also allocating to growth assets can provide a solid strategy for a pension plan. Globally, the market for inflation-linked debt has grown because of the increased demand for reliable inflation-hedging instruments. For LDI portfolios, inflation-linked bonds play an important role, mainly due to their diversifying ability – their low correlation with other asset classes – and capability to provide a risk-free hedge to liabilities.

GET THE RIGHT TOOLS AND GET THEM EARLY

Liability-driven investing is not limited to the consideration of a single asset class; the LDI framework can – and should – be applied across all asset classes to arrive at a holistic view of the volatility of all asset classes relative to the liabilities. It focuses on long-term goals while simultaneously ensuring that acceptable investment outcomes are achieved in the short term.

Ashburton Investments, through its capable and proven LDI capability, offers clients a broader set of tools that help investors implement a sustainable LDI framework. Through a combination of erudite portfolio construction and risk-management techniques, clients are exposed to excellent tools that provide access to different sources of return, including inflation-linked bonds, listed as well as unlisted investment grades and high yield credit.

The business' LDI capability and cutting-edge approaches, are customised to each investor's plan needs, helping institutional investors achieve their goals of minimising surplus volatility and reaching their desired funded status. As investors tackle global recession fears as well as lingering inflation, Ashburton Investments can help plans maintain their desired objectives of meeting their liabilities when they become due. Our approach focuses on each investor's objectives by managing their assets relative to their liabilities, helping to achieve predictability.

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As things stand, uncertainty reigns and investors are scrambling for safety as inflation, rising rates and ill-conceived government policy (as witnessed in the United Kingdom in September) erode asset values.

Balance sheets on average across the JSE universe are strong.

What is clear though is that corporate South Africa remains resilient and has demonstrated an uncanny ability to navigate through volatility

Resilient SA Inc is not the worst place to hide

DANIEL MASVOSVERE

Senior Equity Analyst

These wild variations in sentiment are not without cause. During this period the world has gone through the throes of a pandemic, which saw markets sell off amidst unprecedented global lockdowns.

This was followed by a big market rebound as central banks and governments acted in unison, using the fiscal and monetary policy tools at their disposal to offset the effect of lockdowns and shore up the global economy. The S&P 500 rallied around 38%, an unprecedented move, over the 50 days into June 2020 with similar moves across global markets, including South Africa. The JSE SWIX was up around 65% from its March 2020 low through to March 2021.

However, as the pandemic began to wane, the cocktail of unwinding fiscal and monetary stimulus across developed and emerging markets, together with disrupted global supply chains and a war in Europe, prompted a harsh market reversal in 2022. As things stand, uncertainty reigns and investors are scrambling for safety as inflation, rising rates and ill-conceived government policy (as witnessed in the United Kingdom in September) erode asset values. This has left few places to hide.

AN UNLIKELY BOLTHOLE

Through this period, the South African market has painted a picture of relative resilience.

Early in the pandemic we saw companies on the JSE move to protect their balance sheets, mostly by pulling back on working capital and capex, and a few through rights issues. Banks, corporates and institutional investors alike pulled together, and the depth of the local capital markets was on full display as liquidity was preserved and companies were able to trade through peak lockdown. Debt levels and gearing ratios have trended lower across the JSE universe and, on average, sit below pre-pandemic levels. Across most sectors we have seen earnings recover to - or in some cases beyond - pre-pandemic levels.

Year to date, the JSE SWIX has outperformed the major United States, European and Asian indices. Dividend and cash-flow yields are higher than these other international markets with the average dividend yield at almost 6% for the JSE. At the same time,

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we have seen positive earnings momentum across most JSE sectors this year. Balance sheets on average across the JSE universe are strong. At a price-to-earnings ratio of about eight times, SA Inc still screens cheaper than the S&P, DAX, FTSE 100 and MSCI world indices relative to history. In particular we see the mid- to small-cap space of the JSE as offering attractive opportunities. However, in the short to medium term there is downside risk to earnings across both emerging and developed markets with the International Monetary Fund already suggesting that the world economy is edging towards recession.

This begs the question: What are the risks for South Africa?

State power producer Eskom's implosion means the country is stuck with debilitating power cuts until more self-generated capacity comes on to the grid. However, we have seen government putting in place legislation to support public-private partnerships to help address the capacity constraints.

In addition to many of South Africa's other, well-documented structural challenges - from high unemployment to crime and corruption - the country is also faced with continued political uncertainty as the 2024 election cycle kicks into gear.

What is clear though is that corporate South Africa remains resilient and has demonstrated an uncanny ability to navigate through volatility. Given this experience, coupled with the unprecedented political and economic instability that exists in all global markets currently, right now South Africa is not the worst place to hide.

"At a price-to-earnings ratio of about eight times, SA Inc still screens cheaper than the S&P, DAX, FTSE 100 and MSCI world indices relative to history."

The ugly duckling asset class fluffs up its feathers

LESIBA LEDWABA
Head of Property

Covid-19 and its lingering implications, such as retail and office occupancies and the repurposing of office space into residential units, isn't alone in affecting the sector.

Property-related costs are also escalating at rates exceeding top-line rental growth levels, which is compounded by administered costs such as electricity and rates that have been increasing at rates higher than inflation.

The listed property asset class in South Africa has underperformed most major asset classes, from equities and bonds to cash, over the past few years.

Following the deep Covid-19 lockdowns of 2020, the sector has gained +103.87% on a total return basis from the trough in 2020 to the peak at the beginning of 2022.

Covid-19 and its lingering implications, such as retail and office occupancies and the repurposing of office space into residential units, isn't alone in affecting the sector. Other challenges that were faced by South African listed property over this period include the July 2021 civil unrest and the extensive flooding in KwaZulu-Natal in April 2022, both of which resulted in a number of assets being damaged.

It is encouraging that while issues still persist, there is evidence of some green shoots. This is particularly true of the local retail sector.

What cannot be discounted, however, is the fact that headwinds in the current economic environment abound. Offshore markets, including Central and Eastern Europe, Spain and the UK, account for just under 50% of the overall South African listed property sector exposure by asset value and are facing arguably even bigger macro challenges than South Africa currently.

KEEP AN EYE ON…

Some of these challenges, to single out just a few, include high inflation and the resulting increase in the cost of funding as interest rates continue rising globally in line with central bank intentions to cool high inflation levels. This is highly relevant since the sector's gearing or loan-to-value levels are just under 40%, a somewhat improved level relative to the situation pre-Covid. The cost of funding for real estate companies tends to be among the most material cost-related items.

Property-related costs are also escalating at rates exceeding top-line rental growth levels, which is compounded by administered costs such as electricity and rates that have been increasing at rates higher than inflation. Elevated inflation levels and interest rate increases will also likely have a negative impact on consumer spending which means retail turnover and trading densities will come under pressure. Higher bond yields could have negative implications for underlying property asset valuation yields, especially if they remain elevated for some time and in the absence of good rental growth.

"It is encouraging that while issues still persist, there is evidence of some green shoots."

BUT IT'S NOT ALL NEGATIVE

On the positive side, top-line rental income has shown good improvement having normalised after being negatively impacted during the throes of Covid-19. Certainly, rental concession are a thing of the past.

During the pandemic, the sector provided rental relief to various tenants totalling R3.5 billion. Since then, the retail sector has experienced a positive improvement in rental turnover figures with most centres generating figures above pre-Covid levels. This, to a large extent, implies that tenants are healthy, a development that could well manifest into a positive rental trend as the market's cost of occupancy continues to improve.

The deep negative reversions that have been experienced over the past two years could well mean that rentals have rebased to far more palatable levels. Retail vacancies have also showed signs of improvement as certain retailers have taken the opportunity to expand at a time when rentals are being rebased lower. Most of the resizing and former department store excess space has largely been absorbed. This is evidenced by the reduction in vacancies in retail.

A LONG-TERM HORIZON ASSET

Having a glance at valuation metrics such as forward dividend yields and price to book, an argument can be made that listed property does offer value at current levels and especially if one has a long-term investment horizon.

The sector is currently trading on a forward yield of about 11% and a 31% discount to historic net asset value. Especially considering that rentals have largely rebased to more sustainable levels and underlying property values have faced varying degrees of write downs since Covid-19, it appears that the sector is now turning the corner. Despite these green shoots, a more defensive stance within portfolios is still, however, warranted given the macro headwinds.

"Top-line rental income has shown good improvement having normalised after being negatively impacted during the throes of Covid-19."

SANTHURI THAVER
Head of Credit

There is light at the end of the tunnel

While load-shedding is a national crisis, it is the lesser evil when compared to a potential total grid collapse.

The Renewable Energy Independent Power Producer Procurement Programme remains a long-term investment opportunity into stable assets with continued bid windows being rolled out.

The country has immense potential, with the energy sector reforms moving the country in the right direction.

Amid an uptick in load-shedding, impacted by both planned and unplanned maintenance of Eskom's generation fleet, recent reports indicate that billions of rands in Gross Domestic Product are being lost.

While load-shedding is a national crisis, it is the lesser evil when compared to a potential total grid collapse. The latter would be disastrous from both a financial and social order perspective. Reliable and consistent energy generation is undoubtedly one of the key factors in supporting the further industrialisation of Africa's most advanced economy. This would provide a much-needed boost to economic growth, an increase in job creation and assist in reducing the inequality gap. Sustainable and reliable energy infrastructure is key to maintaining and broadening the appeal of our country through efficient production, lower costs, reduced inequality, and a greater workforce.

BRINGING NEW ENERGY TO INVESTMENT OPPORTUNITIES

While the energy challenge cannot be solved overnight, electricity sector reforms announced by South African President Cyril Ramaphosa in July 2022 provide a pathway to address energy challenges and generate investment opportunities, along with net job creation.

The lifting of the embedded generation threshold and the opportunity to sell back power into the grid opens up power generating opportunities for municipalities and the private sector. We are seeing investment opportunities particularly with the mining houses being some of the largest energy intensive users. One example of this is the recently announced financial close of a 200MW self-generation renewable energy project by Tronox, a vertically integrated titanium dioxide manufacturer with key mineral sands operations in South Africa. This self-generation project would, per Tronox, see 40% of Tronox's energy needs in South Africa being met, as well as a reduction in its global Scope 1 and 2 emissions of ca.13% versus their 2019 baseline. This creates opportunities for micro-infrastructure investment, increasing the self-generation capacity of various industries to enable growth.

PRIVATE SECTOR BENEFITS AND CHALLENGES

Boosting the self-generating capabilities of the private sector provides a number of benefits, namely:

- Enhancing the reliability and stability of power supply to the user to sustain and grow relevant industries.
- Providing greater certainty around the energy cost profile, introducing cost savings as well as improving the sustainability of the business/ sector. Facilitating opportunities for South African construction companies, leading to an increase in contractual and permanent jobs.
- Enhancing opportunities for the development of local communities in and around distributed electricity generation.
- Facilitating a green energy transition that contributes to the meeting of climate goals.

Challenges remain around timing in bringing these own generation capacity projects online as well as environmental permitting and grid connection. The latter will be addressed through the fast tracking of relevant approvals and reduced requirements in areas where the environmental impacts of a project may not be considered high risk.

"While the energy challenge cannot be solved overnight, electricity sector reforms announced by South African President Cyril Ramaphosa in July 2022 provide a pathway to address energy challenges and create investment opportunities, along with net job creation."

“An important factor to consider, as we have learnt from the developed world’s current energy crisis, is that a balanced energy mix remains key”

WHAT INVESTORS NEED TO KNOW

For investors looking to increase their infrastructure investment or enter this sector, the above provides several opportunities in the short to medium term. The Renewable Energy Independent Power Producer Procurement Programme remains a long-term investment opportunity into stable assets with continued bid windows being rolled out.

An important factor to consider, as we have learnt from the developed world’s current energy crisis, is that a balanced energy mix remains key. Given high gas prices in Europe, we are seeing countries such as Germany extend decommissioning dates or restart mothballed coal-fired power plants to ensure energy security. In addition, Europe itself is facing its own form of load-shedding with plans to reduce electricity consumption during peak hours.

Radical shifts between renewable and non-renewable energy should, therefore, be cautioned against. It’s not a case of one or the other, but of creating the aforementioned balanced energy mix to deliver reliable power to support South Africa’s economic growth. As we aim to reach the finish line of 2050 for net zero carbon emission targets, ‘E’ factors (environmental) cannot be considered in isolation. Indeed, the ‘S’ factors (social) also need focus and weight when considering the energy transition. It is key that a measured and phased approach – one that is appropriate for South Africa’s industrial and employment needs - be taken.

FINDING THE LIGHT

While you may be reading this piece by the light of your rechargeable battery pack, know that all hope is not lost. The country has immense potential, with the energy sector reforms moving the country in the right direction. Our focus now needs to be on unlocking this potential to deliver growth, both economically and socially. As author Ada Adams reflects: “There is light at the end of every tunnel. Some tunnels just happen to be longer than others.”

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