INVESTMENT ENVIRONMENT

DOUGLAS INVESTMENTS

Introduction

February was a strong month for US markets largely driven by AI optimism. Fed speakers continued to sound increasingly hawkish and have attempted to push out market expectations for rate cuts. The disinflation trends continued although there are signs of stickiness as we get to the business end of achieving the 2% Fed target.

Q4 2023 earnings season is coming to a close and has generally been in line with expectations with the two most significant beats being NVIDIA and Meta. The market remains highly concentrated in technology as investors remain excited about the AI theme. This combined with increased earnings expectations has resulted in some of the big banks upgrading their price target for the S&P500.

Globally markets have been hitting new all time highs with the US S&P500, Japan's Nikkei and Europe's Stoxx 600 all beating previous peaks. In the case of Japan the previous peak was set in 1989 and it has taken an extraordinary 35 years to reach that level again. Both Europe and the US surpassed highs reached in Covid. This shows how sentiment has been risk on and is despite the ongoing wars that see no sign of abating.

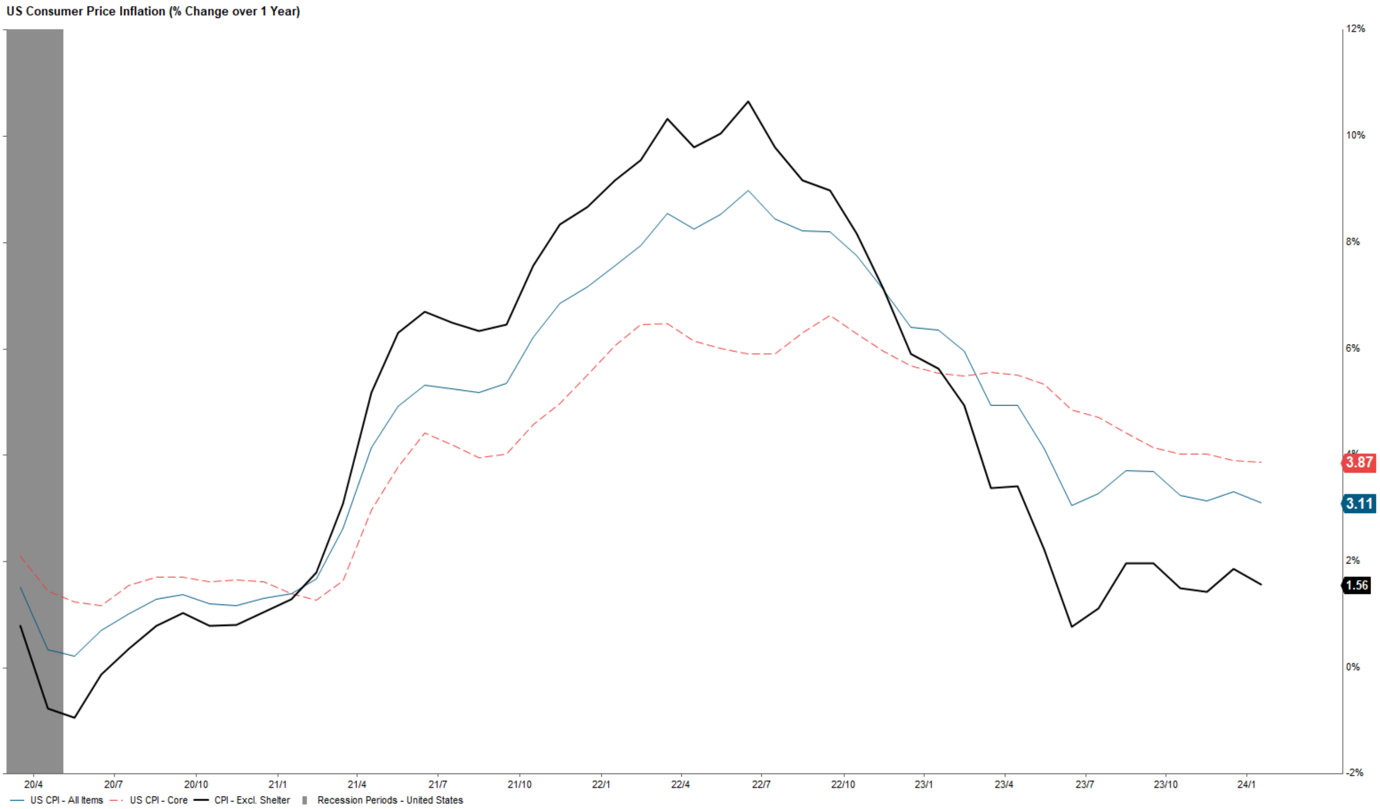
Unfortunately, not all jurisdictions have benefitted from the risk on as the UK has entered a technical recession with two consecutive quarters of negative GDP growth. In addition the stock market has largely moved sideways and although the disinflation trend is present there is still some work to be done.

South Africa has not benefitted from the general risk on stance of markets and headwinds remain. The budget was a balancing act and initially was well received by markets but on further analysis we saw the Rand blow out. This coupled with the election looming (now set for 29 May 2024) we expect most investors to take a 'wait and see' approach as there appears to be limited upside in deploying capital into the current risk environment.

There is no doubt the recent move in offshore markets have benefitted our portfolios based on our technology bias and strong earnings from some of our preferred single stocks. However, we believe expectations are currently elevated with a lot of good news baked in so the current levels provide an opportunity from some profit taking in order to manage portfolio weightings.

Macro Environment

The market is still clearly focused on central bank decision-making especially considering CPI in the US coming in higher than anticipated. As outlined by the chart on the next page the sticky element of inflation is proving to be shelter which is running at 6.1%. If shelter were to be excluded as indicated by the black line then inflation would be running at 1.56% which sits below the Fed target. So should we be worried about the impact of shelter on inflation? It makes up a big portion of the basket (more than 30%); however, the way it is calculated and the nature of rentals having a 12-month lease mean there is generally a lag effect to shelter inflation coming down. If we look at current private market data we see a clear downward trajectory for shelter inflation which is providing comfort to the market. Naturally macro data can change quickly but for now the disinflationary trajectory appears on track but the Fed will continue to wait for official data to confirm this and hence their rhetoric of being patient for rate cuts. The market is now expecting a first rate cut in June which is a far stretch from initial expectations of March.



The South African budget was presented in February with the most notable item being the Government tapping into the SARB's R500bn Gold and Foreign Exchange Contingency Reserve Account (GFECRA) by withdrawing R150bn to assist in stabilising debt levels. This will assist with the interest burden however fiscal discipline needs to remain in place as it should not be viewed as a license for additional spending creep as this will have a negative impact on the countries fiscal position.

Asset Allocation

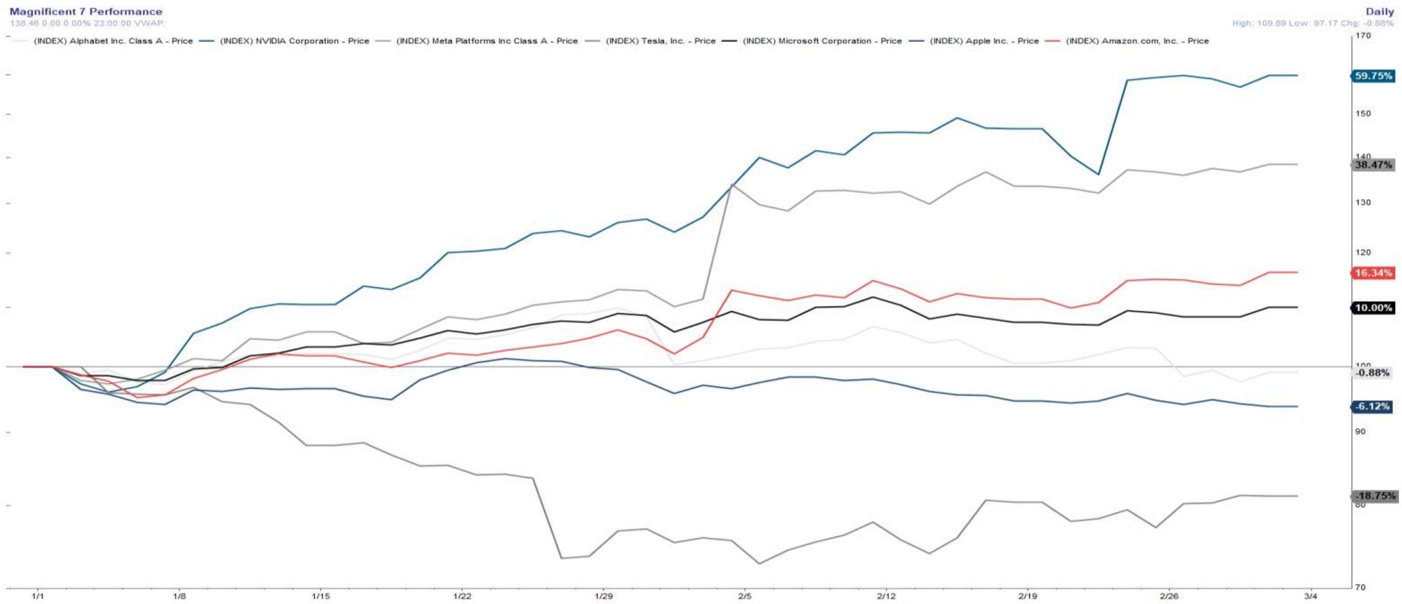
Our asset allocation has seen a slight shift in terms of offshore equity exposure as we feel the strong start to this year has pushed valuations a bit high resulting in an opportunity for some profit taking. Our bond positioning remains unchanged and we have been topping up structured notes where appropriate. Locally our Rand hedge bias remains in place as we allow for the expected volatility leading up to the election at the end of May to play out. Overall we believe portfolios are well positioned following strong growth over the past 5 months.

Market Performance

February was a very strong month for offshore markets while the JSE had another negative month. During the month of February the S&P500 was the star performer seeing an increase of 3.87%. The MSCI World index was up 3.68% for the month and the JSE was down 2.34%. As per chart below the YTD performance of the JSE is -5.41%, while the S&P500 is up 6.84% and the World index is up 6.29%.

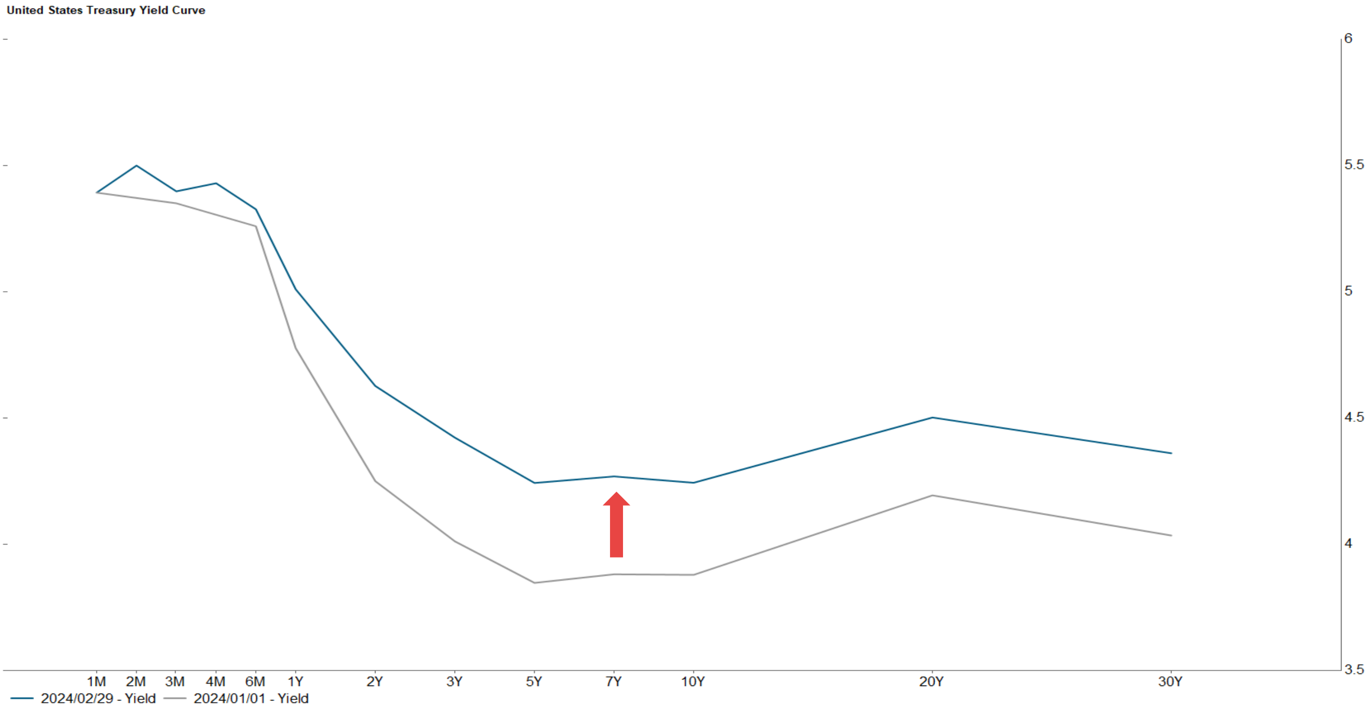
Equities

Fourth quarter of 2023 earnings are drawing to a close and to date the reported growth has been 4% year on year which is a better quarter than markets were expecting. 73% of companies exceeded EPS estimates which although impressive is below the five year average of 77%. A hot topic on earnings call remains inflation and Artificial Intelligence. The star performer of February was once again NVIDIA which continues to surpass even the highest expectations. It is also positive to see there is a broadening out in the general market rally as we positioned portfolios for this towards the end of last year with some of our preferred stocks (outside the magnificent 7) reaching new 52 week highs. The S&P500 equal-weighted index outpaced the cap weighted index by close to 50bps showing the broadening of the rally. It is also notable that not all members of the magnificent 7 are seeing the same growth this year with NVIDIA and Meta the stand out performers whereas Tesla has seen a sell off as can be seen below.



Bonds

Yields have been volatile as the market is trying to digest when the Fed may start cutting rates. As outlined by the chart below bonds with a maturity beyond 2 years have seen the curve shift upwards whereas the shorter end has remained fairly similar. DI believes bonds play an important part in the portfolio but remain focused on Investment Grade in order to limit credit risk with a focus of locking in attractive yields for longer as the anticipation of rates cuts will see money markets drop off quickly when the Fed begins cutting. Moving along the curve and adding significant duration increases the volatility as the market is listening closely to Fed speakers and any market indications for timing of rate cuts which is resulting in yields remaining unsettled. We remain comfortable with our current bond positioning in portfolios.



Conclusion

There is no doubt the start to 2024 has been a good one for offshore markets as rate cut expectations and the AI tailwind are driving a strong rally. This coupled with underlying US macro data that remains strong has rewarded equity positions. DI feels a lot of good news has been priced in and valuations are a bit stretched requiring very strong earnings in order to validate these levels. Although we believe it is important to remain in the market, as trying to time investment and disinvestment from markets has been proven to be ineffective, we are actively managing weightings in portfolios and locking in some profits of our top performers. As earnings season draws to a close we will be monitoring the macro data closely and positioning clients portfolios accordingly.