INVESTMENT ENVIRONMENT

DOUGLAS INVESTMENTS

Introduction

March was the end to a very strong quarter in US markets with double digit returns for the S&P500. The expectations surrounding rate cuts coupled with further excitement around the AI tailwind continues to propel markets forward.

The main event in March was the FOMC meeting where rates were kept at the current level of 5.50% which was exactly what the market expected. Most participants were more focused on the updated Summary of Economic Projections (SEP) which included the updated dot plot. The median policymaker forecast for 2024 continues to see 75bps of cuts, which is unchanged from December, but the market was paying close attention due to some hawkish comments from Fed officials leading into the March meeting. Chairman Powell's post meeting commentary appeared to lean more dovish which the market responded favorably too and helped drive a strong end to the month of March.

Generally, the economic data coming out in March supports the soft-landing narrative although there were some elements such as CPI that came in a bit hotter than expected whereas PCE came in slightly below expectations. The general trend of disinflation remains underpinned by a strong economy, which combination continues to drive expectations of a soft landing.

In addition to expected June rate cuts by the Fed, the market is also anticipating middle of the year cuts from the ECB and BOE. The narrative remains data dependent from most of the central bankers however there does appear to be subtle guidance that we are getting closer to cuts.

Locally the MPC kept rates at the current elevated levels following higher than anticipated inflation coming out. This continues to put pressure on the local economy as both business and the consumer are facing tight economic conditions. South African's still face load shedding on a daily basis although the stages do appear to be improving. Unfortunately, the recent water crisis in Johannesburg hasn't done any favours for the investing community as it made global headlines which doesn't create an attractive investment destination. There are small steps forward in the background with improved work between public sector and private although we are unlikely to see tangible results with the election around the corner and the focus fast shifting to campaigning and winning votes as opposed to running the country. At DI we believe we need to see an outcome of the election prior to being able to increase our risk appetite for South African stocks.

Macro Environment

The chart on the next page from Statista shows the latest dot plot from the Fed which still expects the 75bps of rate cuts that was reflected in the December version. The market has seen a significant adjustment to their own expectations where futures started the year with nearly 150bps of cuts priced in and this has been paired back to align with the Fed's expectations of 75bps. What is interesting to note is that there is still mixed messaging from Fed officials with some speakers believing only a single 25bps of cuts will take place this year. It is difficult to predict what exactly the Fed will do so we prefer looking at the trend, which clearly demonstrates that we are moving into a rate cutting cycle. Although the timing of cuts and quantum is uncertain, we have been positioning portfolios from the 3rd quarter of last year for the change in rate cycle. Obviously, there is always a risk that the Fed holds rates for longer or that they could possibly hike again although we view this risk as very low based on inflation trajectory and the other macroeconomic data points.

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Fed Projections Suggest Three Rate Cuts in 2024

FOMC members' projections for the appropriate target level of the federal funds rate at the end of the specified year*

* Projections as of March 19-20, 2024
Source: U.S. Federal Reserve

Overall, the macro environment in the US is strong although globally there are a number of risks that we should be cognisant of. Markets have largely accepted the ongoing geopolitical tensions, but any escalation will quickly unsettle markets. There is also the political landscape that needs to be monitored with numerous elections and no doubt the biggest one being in the US which looks like a rematch of 2020.

Asset Allocation

Our asset allocation remains largely unchanged where we are just looking to manage weightings across offshore equities and take profit where positions are a bit heavier. This in addition to our allocation to Fixed Income and Structured Notes creates a good balance of risk and reward in these markets that have run hard. Locally we remain in ZAR hedge positions as the election uncertainty drives volatility in local stocks.

Market Performance

March was a strong month for markets with the rally year to date continuing. During the month of March, the S&P500 produced another strong return of 2.79%. The MSCI World index was up 2.05% for the month and the JSE was up 2.79%. As per chart below the YTD performance of the JSE is -3.07% (in ZAR), while the S&P500 is up 10.16% and the World index is up 9.68% (in USD), respectively.

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Equities

With earnings season starting up again in April the market has been focused on conferences with the main event the Nvidia GPU Technology Conference (GTC). The key news event was the release of their chip called the Blackwell which is significantly faster than the predecessor the Hopper and create market excitement for its ability to further drive AI advancement. The chip is made up of 208 billion transistors and is manufactured by Nvidia's partner, TSM, utilizing their 4NP technique.

There has also been a broadening out of market performance as the Magnificent 7 are not the only elements driving the market forward. The valuation discussion continues to be key as multiples are elevated so earnings need to validate this. The global investment banks are seeing a divergence of views again with some upgrading their year-end forecasts for the S&P500 to 5400 while JP Morgan warns of a possible correction.

At DI we will be watching this next earnings season as it kicks off with the banks on 12 April. More companies have issued negative Q1 EPS guidance than positive. Not all companies provide guidance so actual results will be more important, but market expectations are elevated so misses will likely be punished especially for companies trading on elevated multiples. Seasonally we are also entering a lower inflow into equity funds which could put some pressure on equities.

The below chart we have shown our clients before which looks at the trend between forward earnings and the price level of the S&P500. What is clear is that the recent rally has played catch up to some of the ambitious earnings outlooks for 2024 and is now largely in line. This is one of the reasons we think the market has had a good run and now the earnings need to validate this because we would be concerned if price got ahead of earnings as we maintain the view that the fundamentals of equities will revert back to earnings even though there are other factors such as momentum in the short term.

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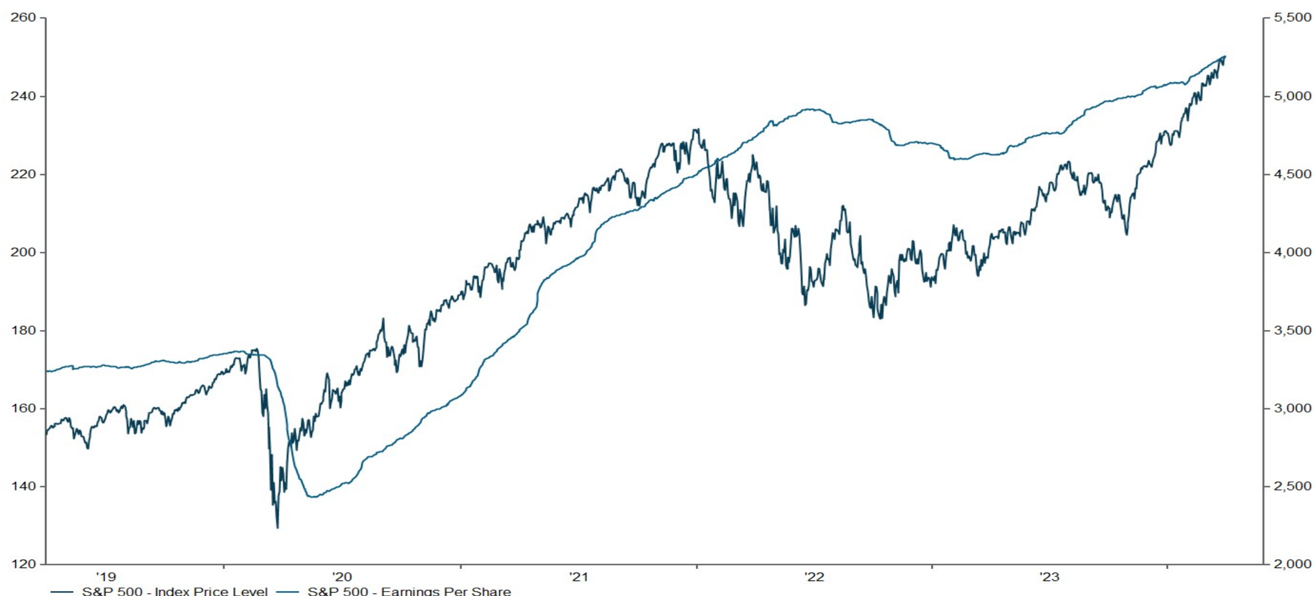

Bonds

Bonds continue to remain fairly volatile as yields move around while the market adjusts forecasts for the rate cutting cycle. In general, the focus is on yield with credit risk less of a discussion although Commercial Real Estate has been flagged as a concern primarily in the US but also in areas of Europe. This follows the shift in working as a result of the pandemic. As outlined by the chart below there has been a 60-bps swing between the high and low of the US 2 year and a 48-bps swing on the 10 year. This is reflected YTD which shows how the market is digesting a path forward on rates. It is clear that earlier in the year there was a greater expectation of rate cuts than there is at the end of March. We still believe bonds have an important role to play in the portfolio although we are not looking to play the volatility but rather lock in attractive yields for a longer period as we enter a rate cutting cycle.

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Conclusion

The offshore market has had a very strong start to the year and our US bias and technology overweight continues to benefit portfolios which have performed well year to date. We do think a lot of good news is priced in with some lofty valuations so have actively taken profit where appropriate and are happy to sit with some cash which will be useful should there be a market pull back. Our bond and structured note positioning is enhancing the portfolio return on a risk adjusted basis. Overall, the general sentiment is positive although there are still risks in the coming months with the Fed receiving three CPI readings before the June meeting where the market expects a rate cut, which is a lot of data to absorb. Locally we remain cautious as we approach the election and look to manage risk in portfolios. We hope all our clients had a Happy Easter and those that have taken time off have had a good break. Please feel free to reach out to the team if you want any further detail on portfolio positioning.

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