INVESTMENT ENVIRONMENT

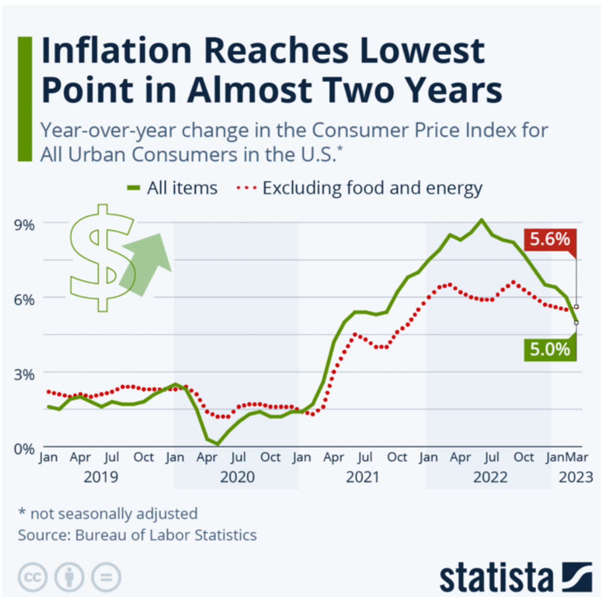
DOUGLAS INVESTMENTS

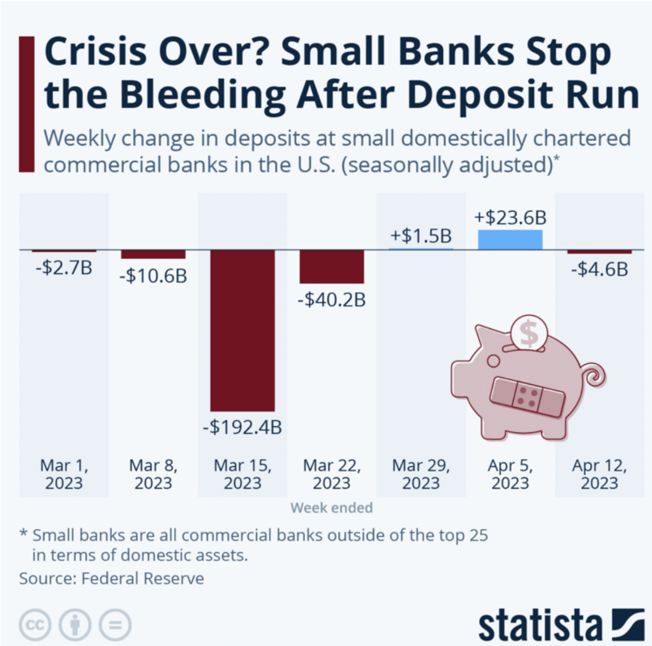
Introduction

April has been an interesting month for markets as the focus shifted back to inflation and central bank rate hikes as the concerns around financial stability eased. It has also been the start of the first quarter of 2023 earnings season with banks as well as a number of big tech names reporting. In between earnings season markets tend to focus on the macro environment and then during the earnings season we see big moves from single stocks based on their results. This was no different in April with the market focusing on inflation numbers and general macro data driving daily moves and some large single stock performance based on results. The US saw a better than expected headline inflation number which renewed hope of a soft landing and some forecasts now expecting rate cuts to take place towards the end of the year. From a markets perspective in the US there is currently a big mismatch between equities and fixed income. The Cboe Volatility Index (VIX) which measures expected volatility in US equities and is largely seen as the measure of 'fear' in equity markets is at the lowest level in over a year and would point to market expectations of a soft landing. On the other hand in the fixed income market volatility is very high and the markets are reflecting a high risk of recession. This disconnect between the two capital markets won't last forever and as additional data comes out we will see which market is the better predictor. The Euro area is presenting a stronger outlook going into summer although inflation still remains high and the ECB has clearly communicated their intention to get this under control even at risk of a recession. In the UK inflation surprised economists again by printing above 10% and putting pressure on the BOE to continue with rate hikes despite the cost of living crisis being faced by the majority of the population. Some good news came from China with growth beating expectations at 4.5% and providing some hope that a global recession would be avoided. Unfortunately the war in Ukraine continues although the market has accepted the long term nature of this and events are having less of an impact on market movements although the devastation continues. Sudan is also experiencing conflict with divisions of the army engaged in conflict and driving an international exit from the region. In South Africa the focus remains on the loadshedding crisis and the detrimental effect it has on the economy. There is still a lot of political jostling but no clear path forward although some commentators believe the private sector will largely solve the generation issues in the next few years although there is concern around the state of transmission infrastructure.

Macro Environment

Inflation is coming down which is good news for central banks although it still remains quite high compared to targets. The Statista chart on the right shows the drop off in inflation in the US which provides a good trend although there is still a concern around the stickiness of services inflation slowing down this trend. The US appears to be leading the way in bringing inflation under control following the very aggressive hikes. South Africa and the UK surprised on the downside with inflation printing above expectations and showing additional work required by central banks. South Africa is already at a decade high Repo rate which puts both consumers and businesses under strain in a difficult operating environment and is likely to add to the negative sentiments gripping the economy.





Following the run on deposits of small regional banks in March it appears calm has largely resumed. The chart on the left outlines the extreme moves in middle to end March and the normalization taking place in April. There are still concerns that exist due to increased emergency borrowings from the Federal Reserve and a standoff between the US Government and the rival lenders of First Republic Bank as regulators have avoided stepping in as the hope is depositor banks will structure a deal to save the bank. It appears to be a case of wait and see who blinks first. This has put banking share prices under a bit of pressure. Overall, the banking crisis on a global scale appears to be contained but we can expect further regional flare ups causing concern where certain banks have mismanaged their positions.

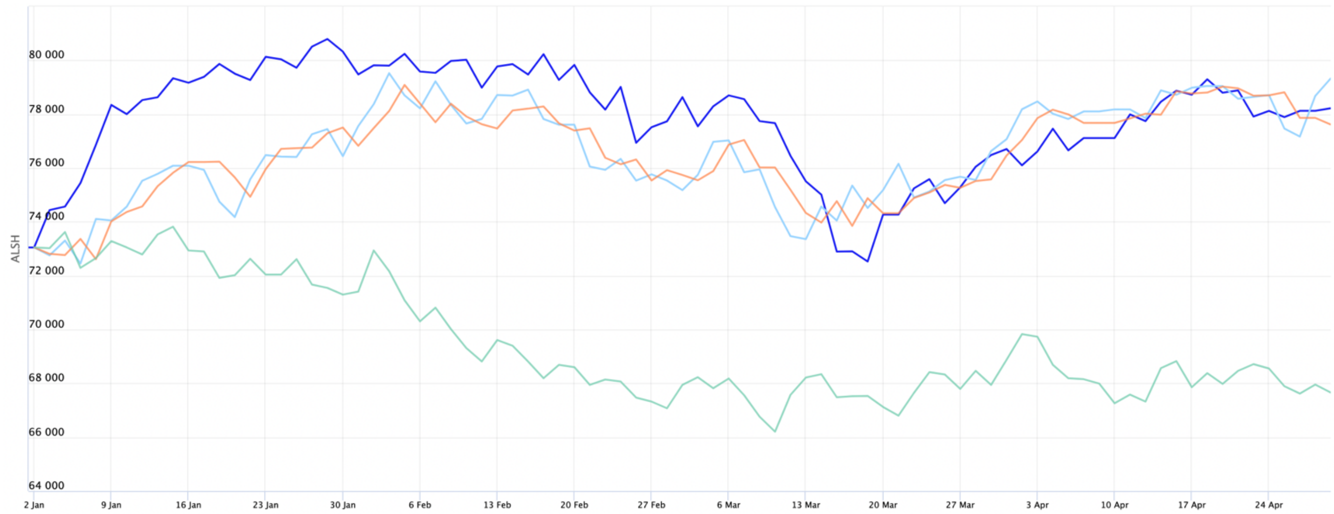
An old debate around the US Dollar dominance and the likelihood of the USD being displaced by a new ‘global’ currency or possibly even a cryptocurrency has reared its head. This is likely driven by geopolitical noise as countries like China and Russia seek to trade in currencies outside of the USD. This sort of news flow grabs a lot of headlines and it cannot be ignored however when one dives into the detail the practicality of replacing the USD is not a near term risk. Replacing the USD is not as simple as a few countries agreeing to trade in a different currency and would require a seismic shift in global markets. Aspects like the size of capital markets, countries debt denomination, trading partners, regulation and trust in the system would be just some of the considerations that would need to be ironed out before this risk becomes material. DI is of the view we likely have decades before this would impact decision making. We are happy to discuss the detail of this should any of our clients have concerns. It is important to note that this is a separate view from the value of the USD relative to other currencies. As previously communicated in other Investment Environments the USD has shown significant strength and is arguably over valued based on certain models but current market uncertainty does aid USD strength as investors view the USD as a safe haven which can result in a disconnect from ‘fair value’ based on currency models.

Asset Allocation

We are comfortable with our current asset allocation as strong markets boosted by good earnings from some of our preferred stocks have benefitted portfolios. Our bond positions are working well and the Structured Products blended income yield is very attractive at 14.5%. Markets have had a good run but there are still risks for the remainder of the year which is in line with our cautious optimism put forward in January. Should inflation continue to come down and central banks reach a peak in the hiking cycle we should have better insights into the outlook for 2024 which could allow for more aggressive positioning depending how the next few months play out. For now we continue to benefit from being in the market but also ensuring we don’t chase stretched valuations and keep a war chest available to take advantage of any attractive opportunities.

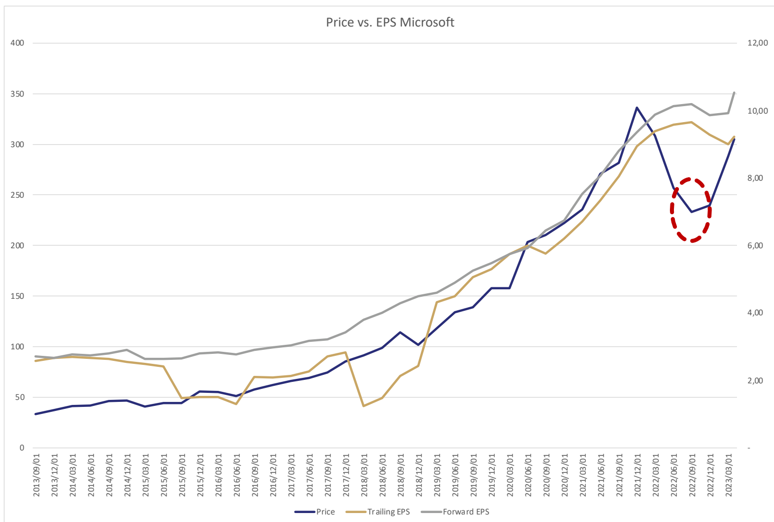
Market Performance

April saw a fairly strong month for US markets as well as the JSE. Globally the MSCI World was down 0.31%. The S&P500 ended the month up 1.09%. The JSE was up 2.09% in April. The chart below depicts the market movements for the year to date with the blue line showing the JSE all share up 7.08% and the green line showing the ZAR/USD exchange rate declining YTD by 7.38%, the orange line showing the MSCI World up 6.25% and the light blue line showing the S&P500 up 8.59%.



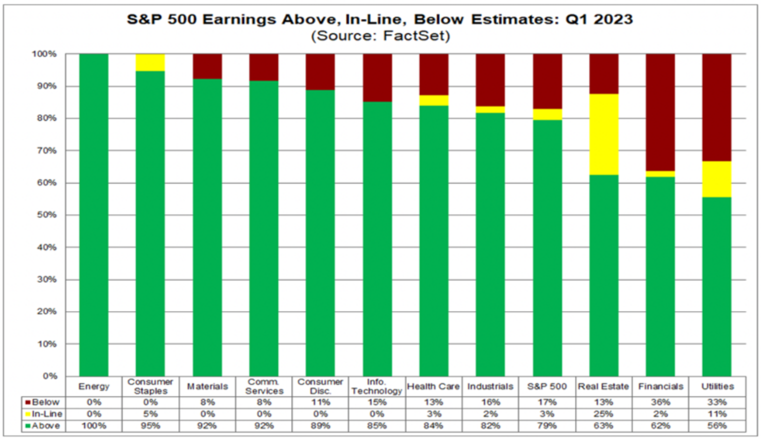
Equities

Equities have remained strong with a number of companies showing strong earnings and beating analyst expectations. Last year we emphasised how some companies, such as Microsoft, showed a clear disconnect between price and earnings whereas more defensive companies were tracking earnings more closely. As per the chart on the right this disconnect has clearly been corrected and companies producing good results are being rewarded. In this regard we are spending significant time analysing results and assessing valuations of our preferred stocks to identify opportunities as well as any positions where we want to take profit.

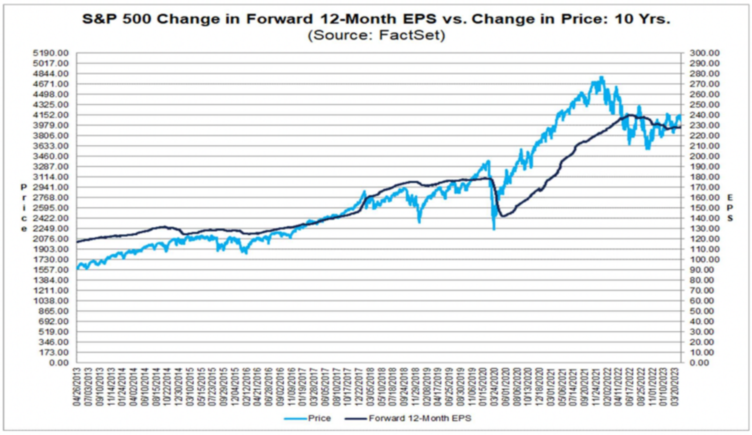


Overall the market has tamed earnings expectations with most analysts downgrading expectations. To date reported results have been better than expected as outlined by the chart on the right. The general market has seen a decrease in earnings of 3.7% which marks the second quarter of earnings declines. This has been in line with our concern that the market valuation as a whole has appeared a bit stretched which can be seen by the second chart on the right. However this is not to say there isn't significant opportunity in the market with a stock picker focus as a number of companies like Microsoft, Google, JP Mogan and others have seen their share price rewarded for their good results.

In South Africa the equity market is facing significant challenges with a clear slowdown in the economy and the typical 'SA Inc' stocks facing a very tough operating environment. Our local portfolios reflect a clear bias towards Rand hedged stocks that benefit from global exposure and the very weak rand. We cannot fault a number of strong SA companies but their investment case is made very difficult by a number of headwinds outside of their control.



	Energy	Consumer Staples	Materials	Comm. Services	Consumer Disc.	Info. Technology	Health Care	Industrials	S&P 500	Real Estate	Financials	Utilities
Below	0%	0%	8%	8%	11%	15%	13%	16%	17%	13%	36%	33%
In-Line	0%	5%	0%	0%	0%	0%	3%	2%	3%	25%	2%	11%
Above	100%	95%	92%	92%	89%	85%	84%	82%	79%	63%	62%	56%



Bonds

As mentioned the fixed income market is showing significant volatility and indicating a high possibility of a recession. US Treasury yields are showing significant moves and hence significant duration can hurt portfolios if incorrectly positioned. DI has remained focused on the shorter end of the yield curve which to date has been easier to manage than the longer end. For now the volatility makes it difficult to add to bond positions in the offshore market. Locally the negative economic sentiment and inflation surprises are keeping yields high so bond investors are needing to remain patient.

Conclusion

Markets remain fairly volatile although offshore equities are showing strength which has been good for portfolios. We continue to monitor the results of our preferred companies and outlook in the current environment to ensure portfolios remain balanced and in the best position to take advantage of any pull backs or rallies. We want to inform all clients that we have moved offices and from 1 May 2023 Douglas Investments new offices can be found at Block C, Homestead Office Park, 65 Homestead Avenue, Bryanston. We look forward to welcoming our clients to our new offices and are fully operational for all our client's needs.