INVESTMENT ENVIRONMENT

DOUGLAS INVESTMENTS

Introduction

December is always an interesting month for markets as the Festive Season break between Christmas and New Year sees very low volumes however there were still significant data events earlier in the month specifically in the US. On the 8th of December we saw the latest jobs report which still reflected a strong labour market and provided support to a strong underlying economy and the views that a soft landing is likely. This was followed by CPI on the 12th December which came in largely in line with market expectations although transportation and housing was a slightly higher but the market still responded favourably to the deflationary trend. The big market mover came on the 13th of December which was the final FOMC meeting of 2023 where the market saw a clear shift to a more dovish rhetoric and consensus from members that the hiking cycle was over with the focus now on cutting rates. Although Chairman Powell attempted to maintain his data dependent stance the market had made up its mind and a strong rally followed. These data points provided a tailwind for markets into the end of the year.

Unfortunately, the wars continue to rage on in December following the short respite in the Israel and Hamas war. President Zelensky visited the US to raise additional funding for their war efforts. Winter provides its challenges and there is no doubt there is fatigue but unfortunately there does not appear to be an end in sight.

Locally South Africa's inflation came in slightly below expectations at 5.5% as a result of lower fuel prices. There has been some easing in loadshedding which has been a pleasant surprise and assists retailers during the busy holiday period which will hopefully boost their results after a very tough year.

The UK saw a disappointing contraction in their GDP coming in at -0.3% which was worse than consensus at -0.1%. The EU has also seen a slowdown and the markets have begun to focus on cuts with high expectations for 2024.

Looking back on 2023 inflation and the central bank response was the clear focus and we expect this to shift in 2024 to rate cuts and what causes this, is it economic slowdown or a soft landing scenario. These two scenarios will have a significant impact on the earnings of companies and in turn market performance.

Macro Environment

The market has been eagerly awaiting the peak of the Fed hiking cycle and now that it appears we are there the positive sentiment shift has been clear. As outlined by the Fed Dot Plot on the following page which summarises Fed Committee members expectations for rates going forward which forecasts 75bps of cuts in 2024 an improvement on the 50bps previously expected. There are also no expectations for any further hikes which is a significant shift from the September position. The markets have interpreted this as a dovish shift by the Fed and that the downward trajectory of inflation will continue. The long term rate has also remained unchanged at 2.5% despite some earlier concerns that this might shift upwards which would have had a negative effect on markets. The market appears very confident that the focus now is on rate cuts and the main question will be the timing thereof. Some forecasts are for cuts as early as March while others move the middle of the year.

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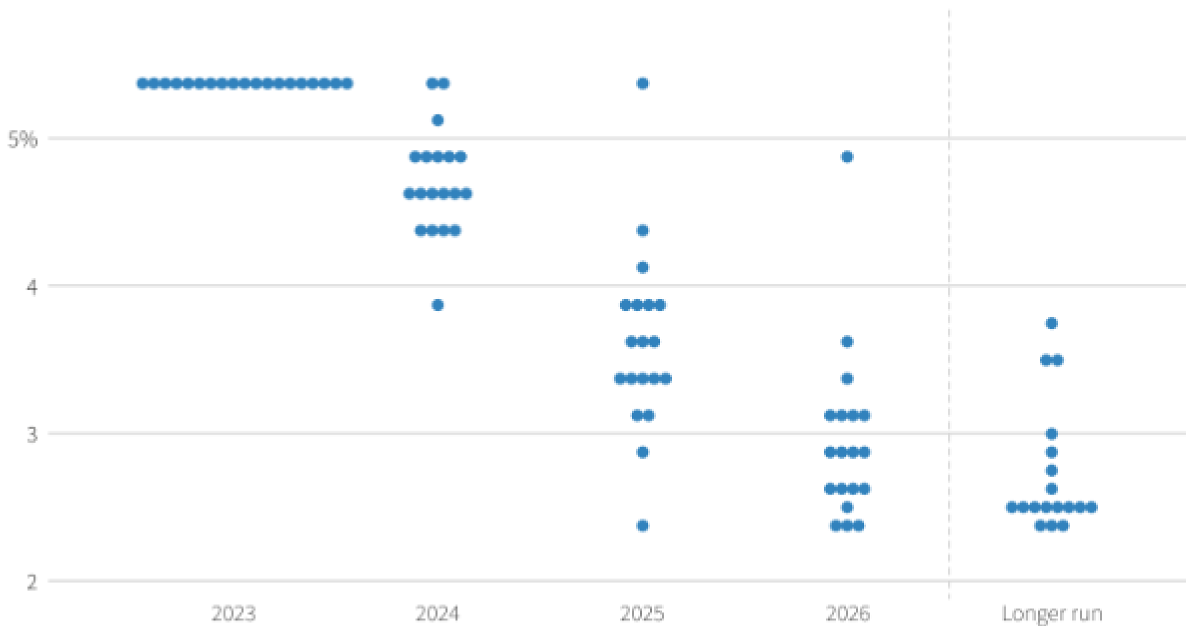

Going into 2024 will also bring a number of elections with Bloomberg estimating that countries producing 44% of Global Output will be heading to voting stations making it a big year for politics. This coupled with the wars in Ukraine and Gaza increasing geopolitical tensions will ensure an uncertain macroeconomic landscape notwithstanding the improved US economic numbers. We will continue to monitor all of these elements as they help inform our decision making in order to achieve the best risk adjusted returns for our clients.

Asset Allocation

Our asset allocation has performed well in 2023 with the recent upweighting of bonds timed well as rate expectations have dropped off. Our equity allocation remains in line with previous months going into 2024 although we are monitoring valuations following the recent rally. Earnings and more importantly guidance starting in January will be very informative for equities. We are continuing with our Structured Notes strategy which has returned our clients around 14% in 2023 and provides a strong income under pin in the portfolio.

Market Performance

December has been another strong month for equity markets with a rally across regions. The S&P500 was up 4.42% for the month while the MSCI World and JSE were up 4.07% and 1.80% respectively. The recent rally has meant the S&P500 has closed the year up 24.2% YTD and the MSCI World is up 21.1%. Unfortunately, the JSE has had a weaker year and it ended the year up 5.3%.

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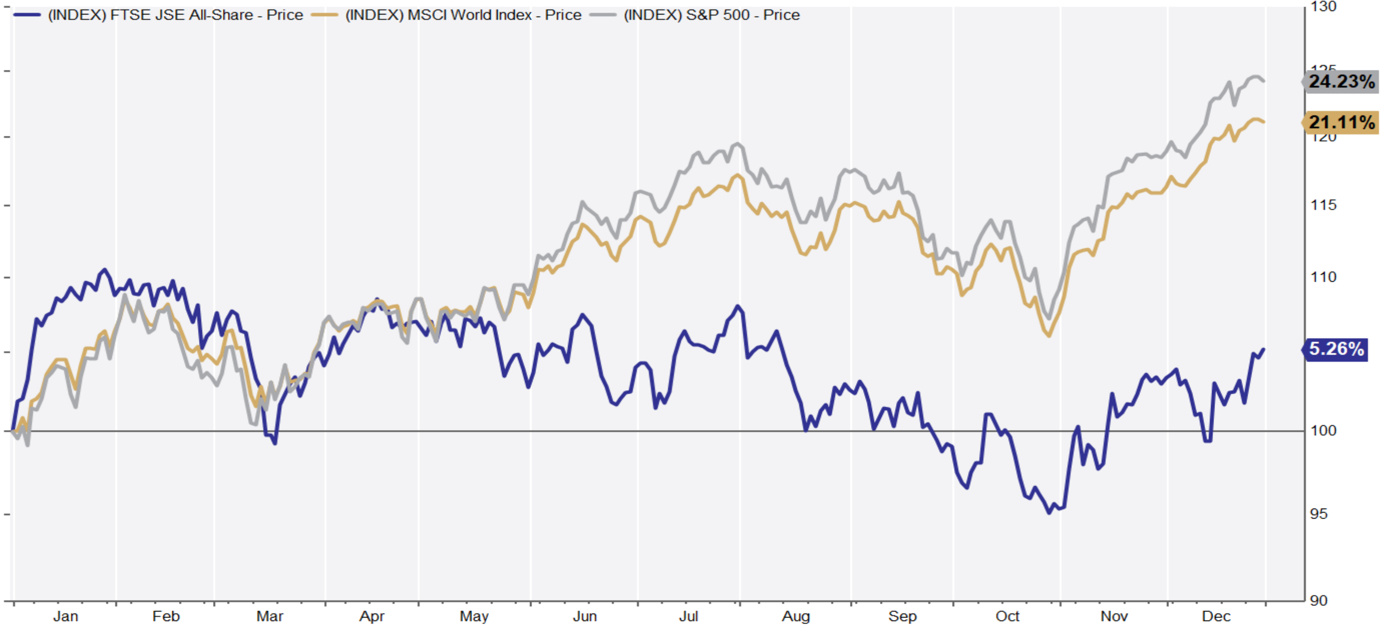

Equities

It is the time of year where all the global banks key strategists provide their forecasts for 2024 with a key focus being the level they predict the S&P500 ending in 2024. The chart below outlines some of the year-end targets. While we don't place much emphasis on these targets it is interesting to understand the thinking behind them. The consensus view for 2023 had a positive outlook on bonds and defensive stocks and a more negative or muted outlook for technology. Looking back that was a very poor call as the star performer in 2023 was technology and bonds only performed towards the end of the year. It is for this reason that we spend time internally debating and doing our own work to decide on asset allocation as opposed to just following other market participants.

So looking at 2024 and the big divergence in forecasts as outlined by the chart on the left largely comes down to earnings expectations. Our focus remains on both the macro drivers and the chance of a soft landing and in turn earnings based on those expectations.

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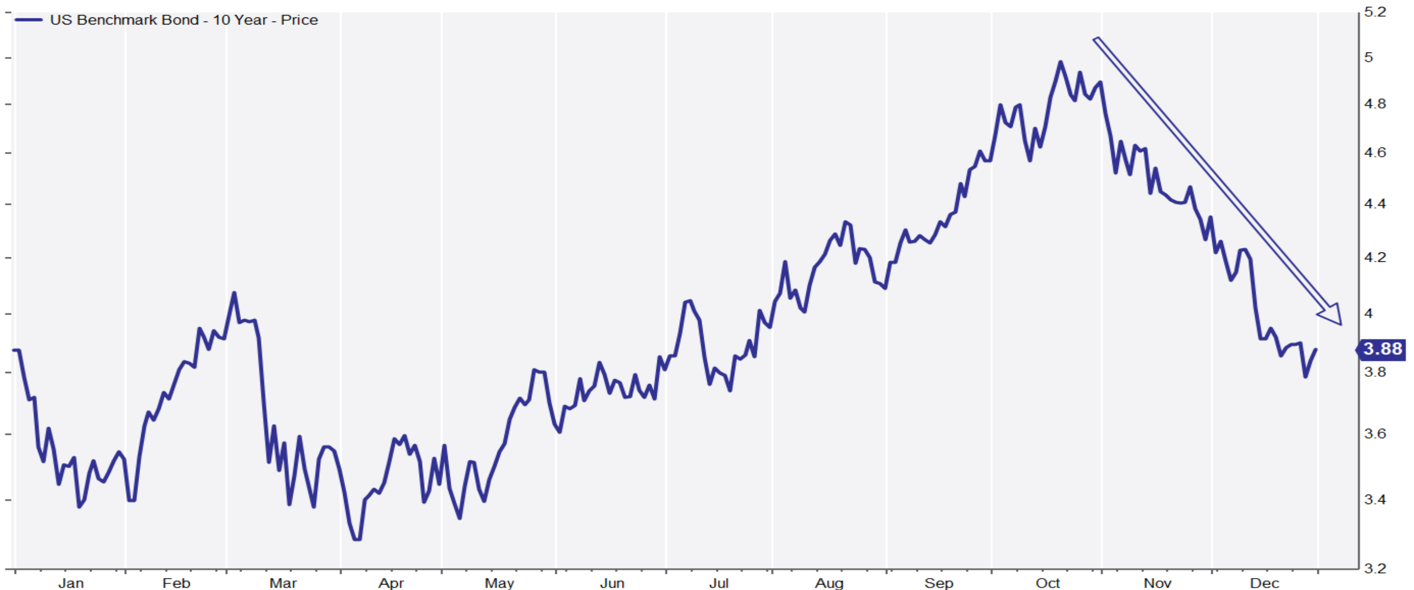
Should the soft landing be achieved and earnings in 2024 ramp up again in line with current expectations then equities should perform well in 2024 in line with bullish forecasts. However, a lot of this thinking has assisted the recent equity rally so any pressure on earnings will not be well received by the market and this is why some strategists are highlighting a more cautious tone. We think the coming earnings for Q4 of 2023 will, as always, be very informative and provide some guidance with the current track record of companies showing their ability to navigate a tricky macroeconomic environment while benefitting from a strong underlying economy in the US. Should this trend continue then equities will likely warrant their current valuations.

Bonds

In line with our recent asset allocation we have become more positive on bonds in recent months based on the rate hiking cycle having peaked and the opportunity to lock in more attractive yield as well as a possible capital uplift in a rate cutting scenario. This also provides some diversification in portfolios as if there is a recession and more aggressive rate cuts result, bonds will provide some protection to the portfolio, whereas equities will likely be under pressure from earnings downgrades. We are not looking to chase bonds into the New Year as we have already upweighted in portfolios and there has been a strong rally in the past two months as outlined by the significant shift in the US 10 Year yield below.



Conclusion

Looking back on 2023 there is no doubt it has been a challenging year where regional allocation, asset allocation and stock selection has been critical to achieve superior returns in portfolios. The consensus view a year ago was far off what played out in 2023 and always reminds us why it is important to avoid getting caught up in the noise and make decisions based on fundamental analysis and thorough debate. We have no doubt 2024 will present a new set of challenges but it is nice to be ending off 2023 with portfolios in a healthy position after a good year of performance. We thank all our clients for trusting us with the responsibility of their money over the last year and we look forward to working with you all in 2024.

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