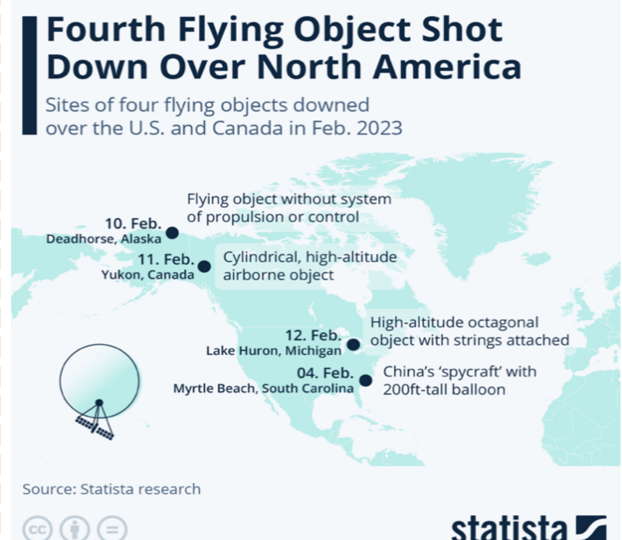
February 2023

Introduction

February was a fairly volatile month for markets as earnings season came to an end and macro-economic factors moved into focus. In general, the Qtr4 2022 earnings season was largely in line with what we expected but muted forward-looking guidance was provided due to the anticipated slow down. The disinflation that markets have been pricing in is still taking place but at a slower rate than initially anticipated. This has resulted in a renewed discussion of higher for longer rates and the market is still trying to unpack the various scenarios from the often spoken about soft landing versus a recession. A third scenario is being put forward termed a no landing which argues the US economy is so strong it will continue showing accelerated growth. Our view has remained the same, which is that the rapid rate hikes are working their way through the economy and the full effects will still only be understood in the months to come. The Euro area looks set to avoid a recession in the short term; however, the UK is likely to see growth falter as inflation pressures and labour issues continue to add pressure to their economy. Inflation in the EU remains hot with both France and Spain showing stronger readings and the ECB terminal rate shifting to 4% for the first time. February marks one year of the war in Ukraine which appears to be set to continue well into the future with neither side looking to compromise and no clear end in sight. China's activity levels continue to pick up as they open up post the pandemic but increased geopolitical tensions and discussion has come with it. Locally, February was a busy month with the Budget taking centre stage. Minister Godongwana presented as good a budget as he could have with the many difficult considerations. The Budget came across less populist with a number of sensible decisions; however, we now need all the words to turn into tangible action and hopefully some policy changes. Andre De Ruyter left Eskom with immediate effect following an allegation filled interview with Annika Larsen. Eskom has appointed Calib Cassim as interim group CEO. While this has all been taking placing South Africa has been in stage 6 load shedding with a record 7 000MW being cut from the grid which should have arguably placed SA in stage 7/8 load shedding. As largely expected, South Africa has been grey listed by the FATF (Financial Action Tack Force) which has done further damage to our reputation.

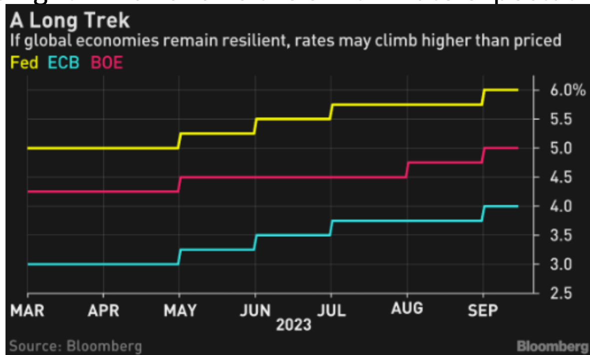
Macro Environment

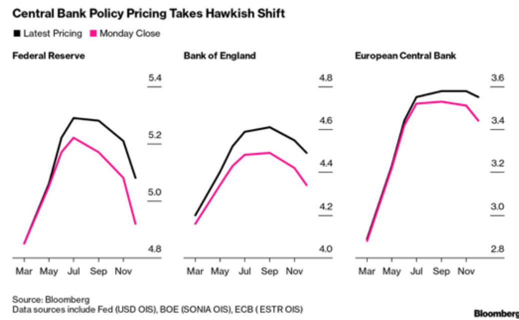
During February, geopolitical tensions between the US and China increased with a Chinese balloon flying over the United States shot down in early February. Following this event there were further objects shot down as highlighted by the image from Statista on the right. These tensions have extended to the Russia-Ukraine war with the US signing off additional funding for Ukraine and China putting forward a peace plan which suggests removing the sanctions over Russia. These geopolitical tensions between the US and China are unlikely to escalate into anything 'hot', as this would be a real black swan event for markets; however, they are important to monitor as they are driving clear themes such as the recent on shoring theme that many US companies are emphasizing.



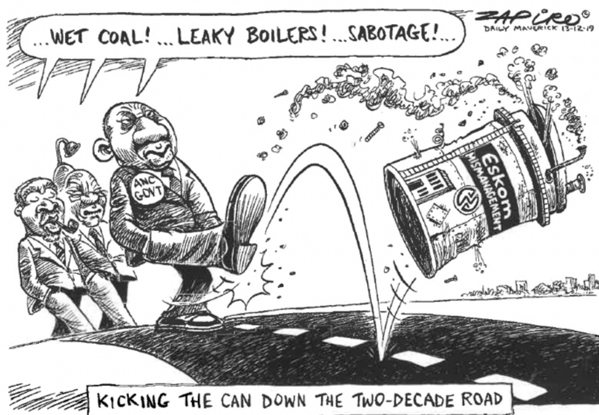
The figures and information contained in this article are based on the best information available to Douglas Investments at the time of drafting; however, no representations or warranties are made or given as to the accuracy of the information contained herein and investors are advised of the risks associated with investments. Douglas Investments shall under no circumstances be liable or responsible for any loss, whether direct or indirect howsoever arising, which may be incurred or suffered arising out of the use of this article

The US disinflation story, although still taking place, has slowed and the jobs market is showing extraordinary resilience with record low unemployment and new job openings far ahead of market expectations. This strength of the labour market is good for the economy but will likely require the Fed and other central banks raising rates higher and keeping them there for longer in order to prevent inflation reversing the current trend and increasing again. Previously markets were pricing in a terminal rate for the Fed of just under 5% but based on recent data this has shifted to close to 5.5% indicating more hiking required than anticipated. If the resilience remains in the economic data rates may even climb higher as per the chart below on the left. Macroeconomic data is still moving markets, which is illustrated by the chart from Bloomberg below on the right which shows the shift in rate expectations as a more hawkish stance is taken by central banks.





The discussion of rate cuts that took place at the start of the year seems to have subsided and there is largely consensus that will only take place in 2024 and the question now is how high the Fed needs to go. The March and May Fed meetings will be clear indicators for markets. Driving more positive sentiment has been the fact that China's PMI rose to 52.6 in February which is the highest level since April 2012 and is a positive indicator for global growth going forward.



13 December 2019

Cyril says mysterious 'sabotage' is somehow involved in causing power shortages, continuing a long ANC tradition of excuses

Locally the Budget was a knife edge balance between austerity and also trying to allocate to key areas. The take on of Eskom's debt will be a positive if it is managed appropriately. Containing the wage bill and not committing to a basic income grant shows good fiscal discipline as this requires a sustainable revenue source to be funded. It was positive to see the incentives for renewable energy installation which will hopefully alleviate some pressure on the grid. Finally, there was an understanding that households and the consumer are under pressure and so the move to not increase broad based taxes was well received. Unfortunately, the macro headwinds still exist with growth being downgraded for 2023 to 0.9% largely hampered by the ongoing load shedding. Loadshedding is nothing new to South Africa as per the Zapiro cartoon on the left back from 2019; however, the finger pointing and blame game continues which is not helping the situation and the focus should be to get back to 60-70% energy availability so the economy can focus on growth.

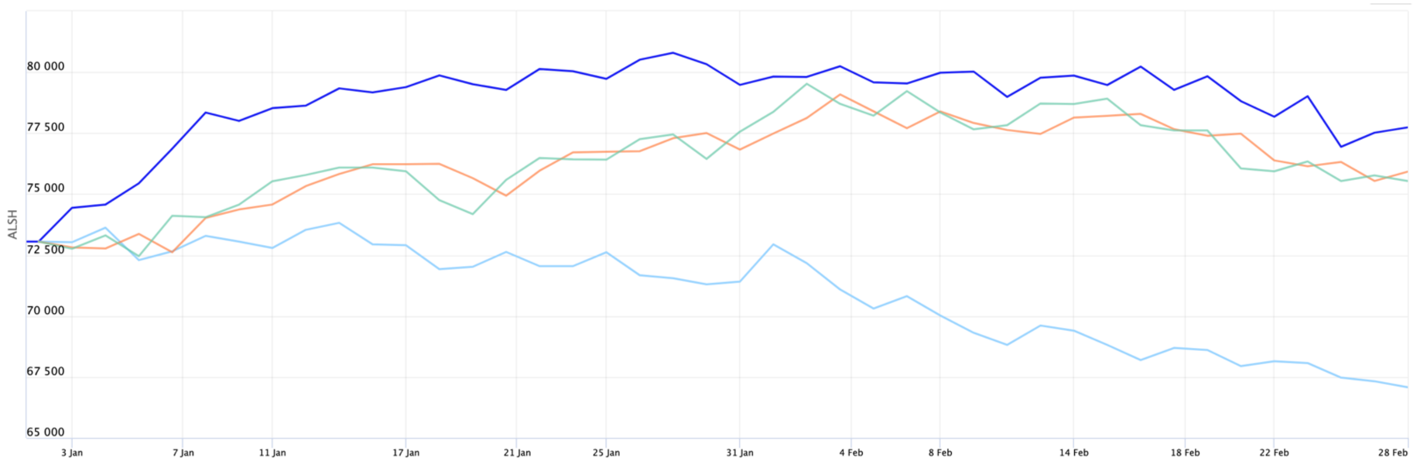
The figures and information contained in this article are based on the best information available to Douglas Investments at the time of drafting; however, no representations or warranties are made or given as to the accuracy of the information contained herein and investors are advised of the risks associated with investments. Douglas Investments shall under no circumstances be liable or responsible for any loss, whether direct or indirect howsoever arising, which may be incurred or suffered arising out of the use of this article

Asset Allocation

In last month's Investment Environment we highlighted our asset allocation with a 50%-60% equity allocation based on current valuations and macroeconomic outlook. Equities continued the strong run into early February and the S&P500 hit a level where we felt valuations were getting a bit rich so we down weighted equity positions to a 45%-55% range in order to remove some risk from the portfolio. Current valuations remain high and based on companies' earnings guidance it would appear that growth will be slow. Accordingly, we are comfortable to remain underweight equities while both the macro outlook and companies guidance finds a more attractive level. Bonds are still providing a good position in portfolios with attractive yield, and we are adding further income to portfolios through structured notes. Overall, we anticipate continued volatility but are comfortable that portfolios are positioned to ride through this cycle. In addition we remain with cash in portfolios to take advantage of attractive opportunities.

Market Performance

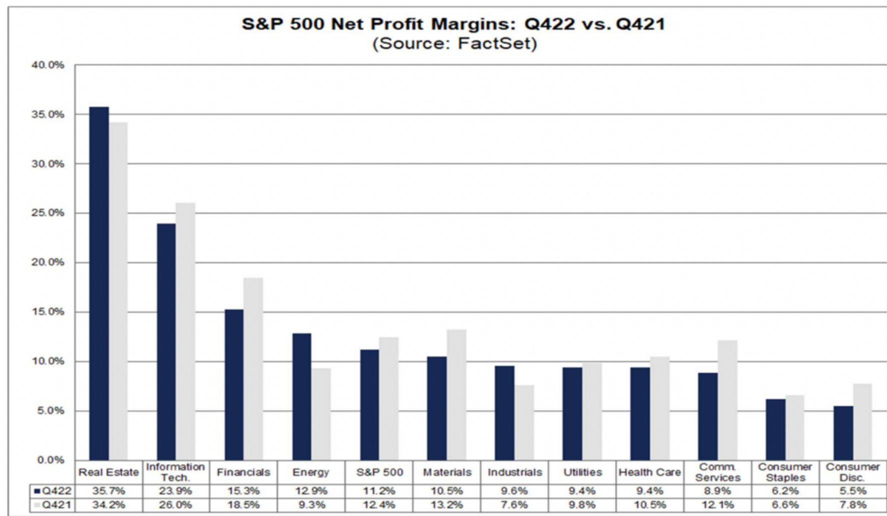
February saw the market under a bit of pressure and equities across the board saw a decrease. Globally the MSCI World was off 2.02%. The S&P500 ended the month down 3.62%. The JSE was down 2.61% in February. The chart below depicts the market movements for the year to date with the blue line showing the JSE all share still up 6.41% and the light blue line showing the ZAR/USD exchange rate under pressure and coming down 8.18%, the orange line showing the MSCI World up 3.93% and the green line showing the S&P500 up 3.4%.

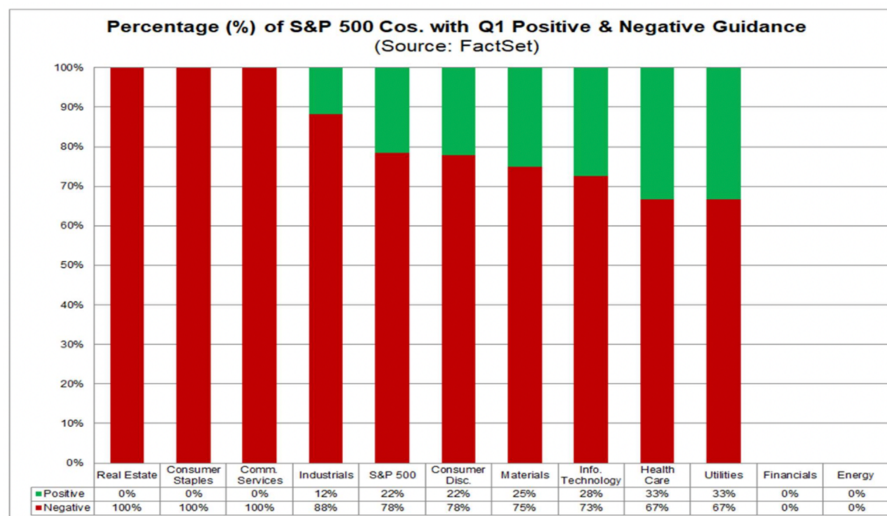


Equities

Following on from January the focus of equities was earnings season for fourth quarter of 2022 and more importantly the guidance for the coming quarter and year. As we have spoken about in previous Investment Environments the muted guidance was in line with our expectations as companies face an uncertain road map for the year ahead with further fed hikes and uncertainty around a recession. There has been a clear trend of margin pressure as many companies struggle to pass on the increase in costs as summarised by the chart on the next page. The market is reacting positively to any mention of cost containment or efficiencies as companies outline how they plan to handle the coming years pressures.

The figures and information contained in this article are based on the best information available to Douglas Investments at the time of drafting; however, no representations or warranties are made or given as to the accuracy of the information contained herein and investors are advised of the risks associated with investments. Douglas Investments shall under no circumstances be liable or responsible for any loss, whether direct or indirect howsoever arising, which may be incurred or suffered arising out of the use of this article





Earnings for the fourth quarter have slightly beaten expectations but the percentage has been lower than both the 5 year and 10 year averages. Earnings expectations have seen a significant downgrade as outlined by the second chart on the left. This has been our view coming into this year that there is limited benefit in providing positive guidance as most companies are facing significant macroeconomic headwinds and general uncertainty. There are exceptions with companies such as Nvidia benefitting from the recent focus of AI and sharing a positive outlook for the year ahead. However, the general reporting sentiment has been focused on slower growth and looking at cost containment and general business efficiencies. As these become priced into the market, we could start seeing attractive valuations providing good entry points.

Bonds

Bonds remain attractive as an income strategy for portfolios and to provide some diversification from direct equities. We are focused on the shorter end of the yield curve and rather holding the bond to maturity as opposed to trying to play duration for capital uplift as we feel there is still a lot of volatility as the uncertainty around inflation and the Fed’s hiking cycle remain. We also do not feel the longer end of the curve is rewarding enough on a risk return basis currently; however, we continue to assess the general bond market as it provides good insights into the outlook and is seen as very efficient.

Conclusion

Although some of the gains from the January rally have been given up we believe our cautiously optimistic approach should remain. We maintain the view that the first half of the year will be volatile with a further negative trend; however, once we have better insights into the effect of the rate hikes it will be easier to take views on the market and in turn investors to construct portfolios with a longer term outlook based on the fundamentals we apply to our approach. As always, the team is available should any of our clients wish to discuss portfolio positioning or general market views.

The figures and information contained in this article are based on the best information available to Douglas Investments at the time of drafting; however, no representations or warranties are made or given as to the accuracy of the information contained herein and investors are advised of the risks associated with investments. Douglas Investments shall under no circumstances be liable or responsible for any loss, whether direct or indirect howsoever arising, which may be incurred or suffered arising out of the use of this article