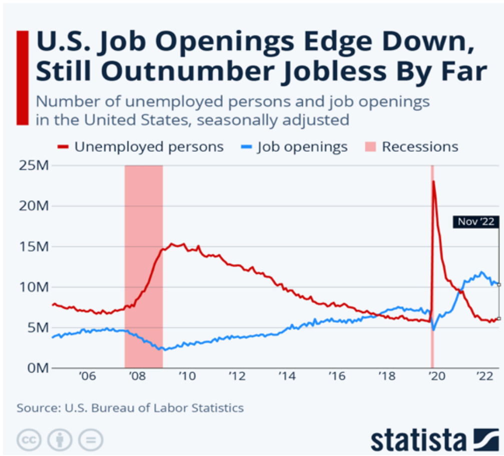
January 2023

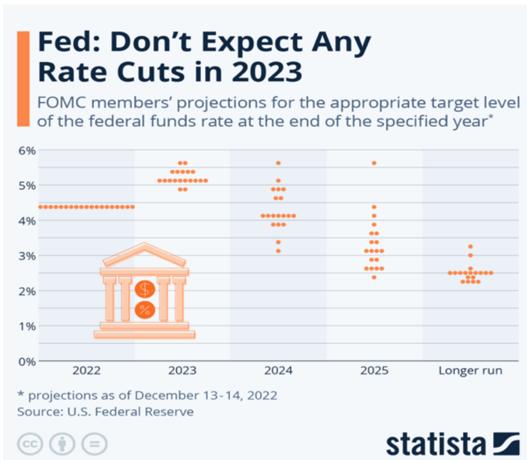
Introduction

2023 has got off to a good start with a positive month for markets in January. General sentiment has improved as some of the bad macro news from 2022 appears to be turning. Douglas Investments is cautiously optimistic for the year ahead as we can see inflation coming down resulting in a slow down followed by a pause of the interest rate hiking cycles, with the likely first mover being the Fed. This bodes well for risk assets and should mean a better year for portfolios. The 'cautious' element to our outlook is important as we are still watching earnings and guidance of companies very closely, as there are clear signs of economic slowdown and companies are apprehensive about the year ahead with limited growth expectations. The market appears to be moving to a soft-landing expectation but there are still clearly recession risks on the horizon that need to be monitored as this could change sentiment quickly. Our current asset allocation ensures client portfolios are in the market, and hence benefit from the good start to 2023; however, we are not looking to chase this rally with new money as we want to have further insights from the ongoing earnings season. Overall, we continue to anticipate volatility in the first half of 2023 as the market looks for direction as we get to the top of the hiking cycle. There are likely to be some attractive opportunities to enter the market in the coming months. Portfolios are well positioned for our cautious optimism, and we continue to apply fundamental analysis to our decision making process.

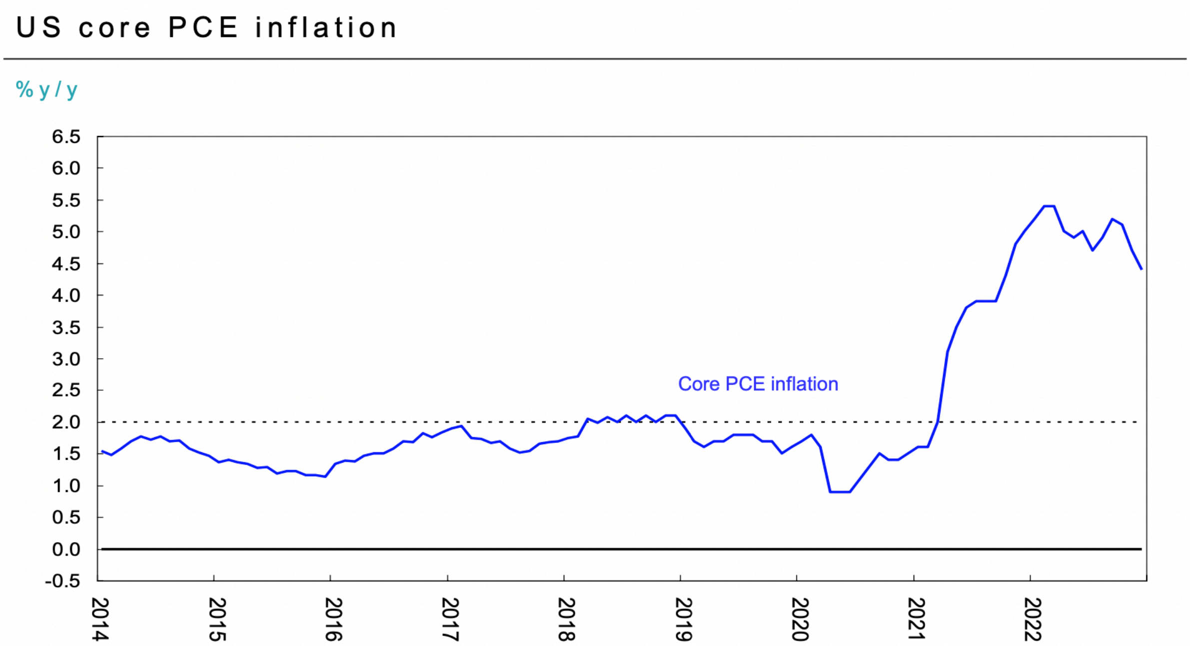
Macro Environment

The start of the year has resulted in a more positive macro-outlook due to a number of tailwinds benefitting the environment. The reopening of China has been good for global growth as China is the second largest economy in the world, so the knock-on effect has been significant. Europe has had a milder winter than anticipated and this has meant gas reserves are currently at the highest levels for this time of the season since 2010, which has effectively reduced the current risk of an imminent energy crisis to zero. This in turn has lowered the risk of a recession in Europe. Inflation has also provided some positive news as it continues to trend down from the peak of 9.1% in the US to current levels of 6.5%. The one area that is cause for concern is the labour market, which remains strong as outlined by the Statista chart on the right - there are far more job openings available than people unemployed. In essence the US remains at full employment. With inflation coming down the market is hoping for a Fed pause on rate hikes and then rate cuts towards the end of 2023. As per the dot plot chart on the right the Fed is only expecting to start cutting in 2024. The market is also pricing in a lower terminal rate than what the Fed is currently indicating so participants will continue keeping a close eye on the rhetoric coming from the Fed's press conference later today (1 February) post their latest rate announcement. 25 basis points is largely expected with anything else catching the market by surprise.





One of the tailwinds in 2023 has been inflation coming down as per the chart below which reflects Core PCE (Personal Consumption Expenditure). PCE is the Fed's preferred inflation measure, a slightly different index to CPI, which is what is normally quoted. However, both measure inflation and need to come down to be in line with the Fed's target of 2%. The trajectory is positive and driving market sentiment, but it is important to keep a close eye on this as it is still at very elevated levels and has a long way to reach target with a risk of sticky elements (such as labour) potentially causing it to plateau at a level above the Fed's target.



Source: Stanlib weekly economic review in charts: 23 Jan to 29 Jan

The current macro environment is more favorable than what was experienced in 2022. There is no doubt there are still risks on the horizon that need to be monitored but the data coming in shows inflation slowing, which points to a peak in rates and in time central banks can start to bring them down. This would all be good for markets. It is important to note that an economic slowdown is expected and largely priced by markets, but should the slowdown be more extreme or longer than anticipated then markets would face headwinds. The IMF released their updated forecasts for 2023 and the only G7 country currently expected to contract is the United Kingdom.

South Africa is facing significant macroeconomic headwinds as a result of the extensive load shedding that is being experienced and for which there is no short-term solution. This will continue to put strain on the economy and additional pressure on an already overburdened consumer. Although there are still opportunities within the South African context it is important to diversify away from direct SA risk where possible and all our portfolios are structured accordingly.

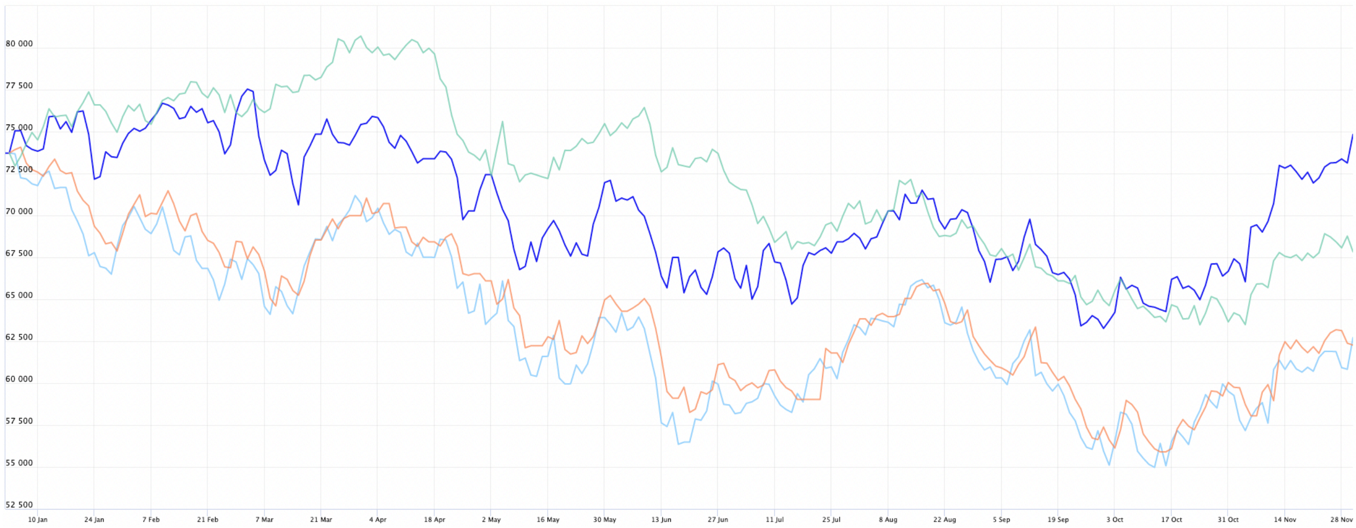
Overall, our cautiously optimistic approach considers the positives of the current tailwinds while still monitoring the risks on the horizon and ensuring our asset allocation is setup appropriately for all our clients' portfolios.

Asset Allocation

As we have written about before, towards the end of 2021 we reduced equity weightings in portfolios in favour of cash due to concerns of equities being overvalued and therefore wanted to create some protection and build a “war chest” to be deployed when markets pulled back and there were attractive re-entry points. 2022 was a volatile and challenging year for markets and we remained conservative on our house-view equity allocation between 50-60%. Bonds were unattractive due to the rapid and steep interest rate hikes causing us to have a significant cash weighting of up to 50%. As mentioned above, we remain cautiously optimistic on markets going into 2023 and therefore have maintained an equity weighting of around 50-60%; however, we are starting to see opportunities in the bond market, which is discussed below. In addition, towards the end of 2022 we started introducing structured notes into portfolios. These notes are bespoke to Douglas Investments where we structure the note in partnership with AIS Financial Group. We are using the structured notes strategically in our asset allocation to enhance yield in portfolios. In summary the main shift of our asset allocation at the start of this year has been to deploy cash into both bonds and structured notes in order to add yield and diversification. We still sit with strategic cash positions to take advantage of an equity market pull back.

Market Performance

January has been a good month for equities with positive sentiment driving markets up. Globally the MSCI World was up 5.17%. The S&P500 ended the month up 6.18%. The JSE was up 8.8% in January. The chart below depicts the market movements for the month with the blue line showing the JSE all share and the light blue line showing the ZAR/USD exchange rate (down 2.24%), the orange line showing the MSCI World and the green line showing the S&P500.



Equities

Earnings season is underway in the US with the banks reporting in early Jan as well as the likes of Microsoft last week and the rest of big tech to report in the coming days. In general results for the fourth quarter of 2022 has been in line with or slightly ahead of expectations, which has been positive. However, the guidance of companies has been more muted with cost pressures being cited and a slowdown in growth. This has largely been in line with Douglas Investments thesis that was explored in previous Investment Environments. The results to date have not been cause for major concern but they do indicate some pressure for companies and hence the cautious approach. In general, the US market does not appear cheap based on current valuations. We are comfortable with our current asset allocation to equities as there are still a lot of unknowns making the outlook for the first half of 2023 uncertain. As we get through two earnings seasons and hope to continue seeing inflation coming down, we expect the outlook will become clearer and it will be easier to invest in companies on a purely fundamental basis with less of a discount for macro uncertainty. It is important to stay in the market during these volatile times but to also avoid getting caught up in the hype of a market rally and rather stick to decisions based on fundamental research, analysis and discussion.

Bonds

A positive of interest rate hikes is that it has put income back into fixed income. After a tough year in 2022 bonds are attractive once again from both an income perspective as well as possible capital uplift. Despite the performance last year Bonds do still provide diversification to a portfolio and hence as part of our asset allocation process, we have started adding bonds to clients' portfolios. Our current focus is on the shorter end of the curve due to more attractive pricing, and we are minimizing credit risk by focusing on Investment Grade issuance.

Conclusion

It is nice to start the year on a positive note after what was a very difficult 2022 for our clients. Our cautious optimism will hopefully allow for 2023 being a year of opportunities despite some of the challenges still working their way through the system. Our clients' portfolios have been positioned accordingly and we continue to identify opportunities that will add value to portfolios. The team is available to discuss our outlook and positioning in more detail as well as plans for the coming year.