INVESTMENT ENVIRONMENT

DOUGLAS INVESTMENTS

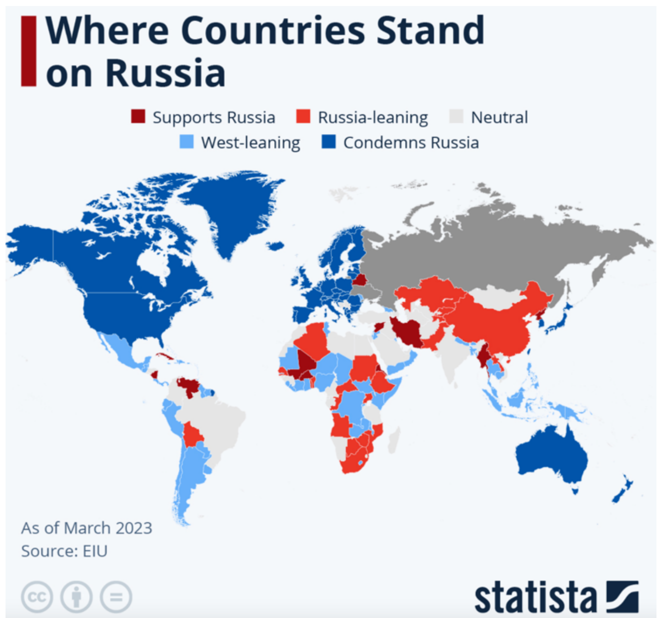
Introduction

May saw the end of first quarter earnings season with continued strength from the Technology sector in the US but some headwinds coming through in retail. The US debt ceiling concerns came into focus in May as the X date (when the US would miss payments) was expected in early June. An agreement in principle was reached over the Memorial Weekend which put the US on track to avoid a default and the house passing the bill on 31 May 2023. A focus on Artificial Intelligence (**AI**) has driven stocks seen to benefit from AI going forward to new highs with the stand-out performer being Nvidia. Concerns around the banking crisis continue to worry markets in early May with JP Morgan rescuing First Republic Bank and the regional banking sector seeing pricing pressure. This volatility has calmed down as the market shifted focus to other Macro matters. The Fed increased interest rates by 25bps which was largely anticipated; however, the focus has shifted to whether a pause or "skip" is coming next with the majority of the market expecting one earlier in the month but some recent macro data has left a further hike as a possibility. The ECB increased rates by 25bps and provided a strong view of further rate hikes in order to bring down inflation. The BOE has lost some credibility with market participants due to large changes in their forecasts and requiring further hikes to bring inflation under control. The BOE hiked by 25bps in May. Inflation continues to come down keeping markets positive that central bank policy is working; however, certain elements of the basket still remain high and further work is needed.

The South African story during May took a significant knock as further own goals were scored. Eskom has continued with stage 6 load shedding which is crippling many businesses and having a detrimental effect on the standard of living of the population. It has also been largely reported that Stage 8 might well become a reality during the winter months. Unfortunately the bad news doesn't stop with load shedding as the Rand blew out to record levels following an accusation by the US Ambassador that South Africa supplied weapons to Russia. This has been exacerbated by further moves made by the Government indicating a closeness to Russia that is far from the neutral stance that was communicated last year when the war broke out. South African inflation remains above the SARB target band and is not being assisted by the poor policy decisions. Food inflation remains incredibly high and is having a significant impact on the population exacerbating poverty and other struggles faced by many people in South Africa.

Macro Environment

South Africa (**SA**) is in a precarious position as the world views our Government as leaning towards Russia as per the Statista chart on the right. This has had detrimental impact on the ZAR as it reached new highs above R19.80 to the USD. It is still unclear whether Putin will join the BRICS Summit being held in SA in August but if he does in theory SA should arrange for his arrest as per their agreement with the ICC. However general indications are that SA will ignore this, which is further driving the rhetoric of SA 'cosying' up to Russia. From a trade perspective this is of grave concern as the West is a far larger trading partner to SA than Russia and should they look to implement any sanctions the impact would be crippling to an already struggling economy.



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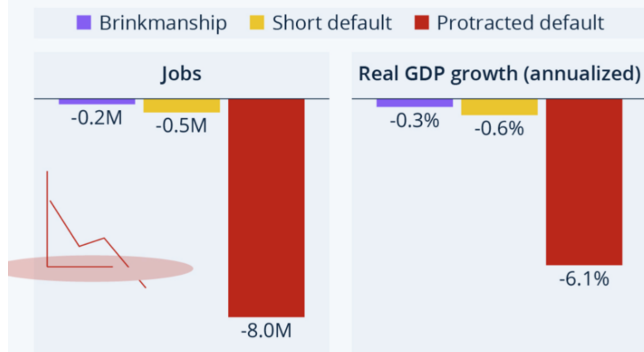

Following earnings in May the market focus quickly moved to the looming debt ceiling and the risk of the US not lifting the ceiling in time to make required payments. The Debt ceiling has been lifted more than 70 times historically so the market generally takes it as a given that a deal will be reached, but Democrats and Republicans use the decision as a political tool with neither side wanting to return to their party empty handed from the negotiations. A deal was put forward to the House on 31 May 2023 which President Joe Biden and Speaker Kevin McCarthy were fairly confident would attract the required number of votes although there was still noise in the system from some of the conservative Republicans. Fortunately the bill passed reducing the risk of any default. Next up is the Senate where approval is nearly a certainty. The charts on the left indicate the very real impact a protracted deal would have on the US economy.

Geopolitical tensions continue to be a discussion point as the relationship between China and the US appears to be strained. Both sides are trying to limit access to certain technologies especially in the semiconductor space with 'National Security" concerns frequently referenced. Interestingly two business leaders being Elon Musk of Tesla and Twitter as well as Jamie Dimon of JP Morgan visited China during May and have both reiterated their commitment to continue doing business in China. This indicates the importance of China in the global economy and although geopolitical noise is expected to continue investors cannot simply ignore China. This has been further emphasised by the anticipated China boom post opening up from Covid not quite materializing as the market anticipated. This has a knock-on effect to a number of companies that rely heavily on China for growth.

Overall the macro environment is seeing a slow down largely driven by the extreme hiking by central banks and this has largely been anticipated for 2023 as the higher rates work their way through economies. Both the US and EU economies are still holding up despite the tighter environment however the same cannot be said for SA which appears to be buckling in the current environment.

Asset Allocation

Our current asset allocation remains conservative as the S&P500 trades at the upper end of our range. Our offshore bond positioning continues to work well despite the volatility experienced from the debt ceiling negotiations. The local bond market remains challenging with the economic and political environment making SA bonds less attractive. We have limited positions in SA bonds but are assessing these over the coming months. Our structured product positioning continues to work well in a largely sideways but volatile market bringing an attractive yield to the portfolio. From a thematic perspective we have seen a benefit from technology positions, as a preferred sector at DI, seeing a strong run YTD. However, certain technology valuations are looking a bit stretched so DI has been actively trimming positions to lock in some of the strong returns.

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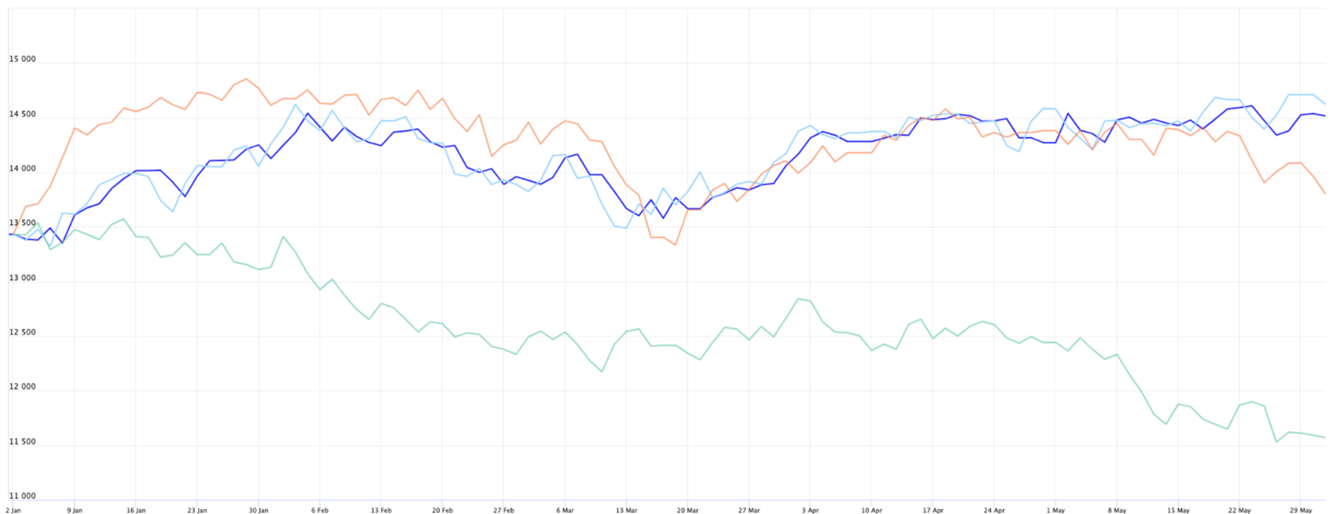
Market Performance

May saw a fairly volatile month for US markets driven by the AI craze. The JSE on the other hand was very weak. Globally the MSCI World was up 1.7%. The S&P500 ended the month up 0.29%. The JSE was down 4.03% in May. The chart below depicts the market movements for the year to date with the orange line showing the JSE all share up 2.76% and the green line showing the ZAR/USD exchange rate declining YTD by 13.86%, the blue line showing the MSCI World up 8.08% and the light blue line showing the S&P500 up 8.86%.

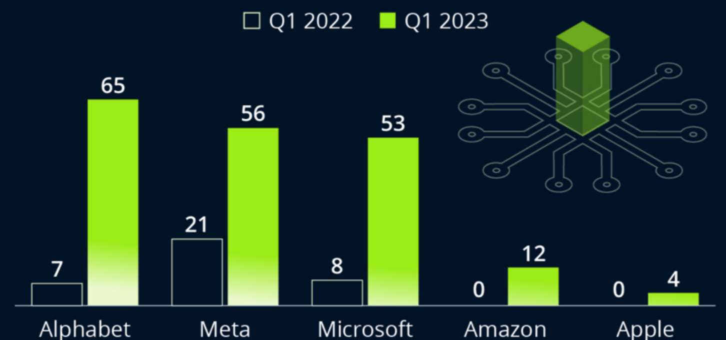


Equities

Equities had a strong month largely driven by technology and specifically the buzz around AI. In recent earnings calls it seemed compulsory to mention AI and how the business was positioning to take advantage of the benefits. As outlined by the Statista chart on the right it is clear that big tech is very focused on AI compared to a year ago. This has driven strong market performance but this is largely as a result of their weighting in the Index. The S&P500 index is up c.9% this year driven by technology; however, if an equal weighted view of the index is taken into account then it would be slightly down year-to-date which indicates that the majority of companies are actually down year-to-date but market performance is being skewed by the big tech performance. DI has always favoured big tech and hence portfolios will have benefitted from this performance.

Tech Giants Were All About AI This Earnings Season

Mentions of "AI" in selected tech companies' earnings calls in April/May 2022/2023*



* incl. mentions of "AI" in analyst/journalist questions; excl. mentions of "AI" as part of brand/company names (e.g. OpenAI)

Source: Statista analysis of earnings call transcripts

statista

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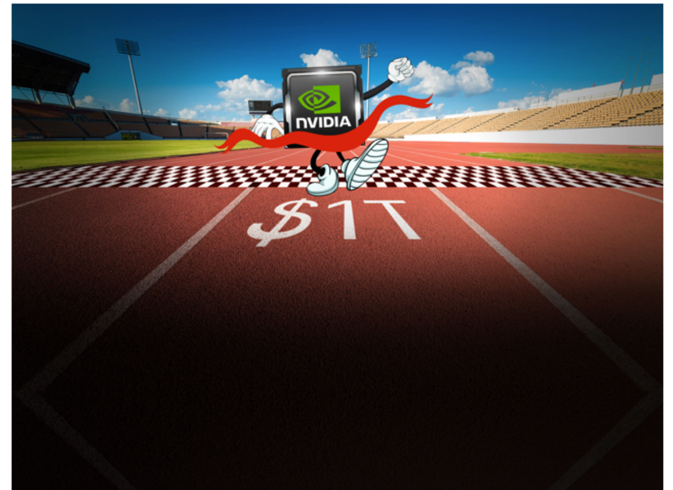
The biggest equity news story of May has been Nvidia's incredible price surge and its resulting market cap passing $1 trillion. This makes it the first semiconductor company to breach the $1 trillion mark.

Apple also posted their first quarter results in May and their iPhone sales surprised on the upside which drove a nice rally in the stock price. In general the US market is at the high end of our valuation range as it hovers around the 4 200 mark. There are still concerns around earnings and the market is anticipating inflation to continue its downward trajectory and is further pricing rate cuts late in 2023. This has all driven some positive sentiment although we think our cautiously optimistic approach remains in place as there are still risks on the horizon and it is important not to chase stock runs and rather be patient ensuring we deploy cash on a fundamental basis.

Locally we are concerned about 'SA Inc' equities due to the significant headwinds facing the SA economy. On this basis we prefer our Rand Hedge approach to local portfolio construction as it helps mitigate some of the risk being faced by local portfolios. There are still some opportunities in the SA market although a long term outlook is required as short term volatility is expected to remain.



Bloomberg Daybreak via Getty Images

Bonds

Offshore bonds are still presenting attractive opportunities at the shorter end of the curve with attractive yields and limited risk if held to maturity. We remain focused on US Treasuries and Investment Grade Corporate as we do not believe High Yield is attractive in the current environment especially with the tightening that is anticipated following the banking concerns. Locally the SA bond market is being moved by political noise and the knock-on effect to sentiment which makes it difficult from an investing appetite although there is hope that with better policy decisions and global sentiment there could be a sharp recovery

Conclusion

May was a month of two tales with offshore portfolios showing strong performance while the local market was difficult. There is no doubt the global economy is slowing down as a result of Central Bankers work last year but a number of economies remain resilient and there are still pockets of opportunities. We are actively reviewing portfolios to manage risk going forward and take profit where required. We anticipate further sideways markets in the coming months with any pullback presenting opportunities and the correct asset allocation remaining critical in this environment. The Fed's next move on the 14th of June could well set the tone for the second half of 2023 so we will be watching with interest.

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