INVESTMENT ENVIRONMENT

DOUGLAS INVESTMENTS

Introduction

October has been a long and challenging month for markets with significant volatility and a fairly bearish sentiment.

An attack by Hamas in Israel sparked a war in the Middle East with Israel responding by significant strikes and a limited ground invasion in Gaza in an effort to eradicate Hamas. The war has re-emphasised the fractured geopolitical state of the world currently. To date the impact on markets has been fairly limited outside of a very volatile oil price. However, the market is very cognisant of the risk of escalation based on comments made by Iran and the high tension in the area. Currently diplomatic channels are being used to try and avoid escalation but there is no doubt the situation is adding to market uncertainty.

Volatility in the Treasury market has been another key theme, as the higher for longer rhetoric coming from the Fed has resulted in the longer end of the curve seeing a significant shift up while the shorter end has remained largely static. This has resulted in a flattening and an easing of the inversion that has been present for most of this year.

Macroeconomic data coming out in October reflected a resilient US economy with a strong labour market and phenomenal GDP growth of 4.9% for Q3, which beat most estimates. The Fed's next announcement comes out this evening (1 November) with the market expecting rates to be kept on hold, but Chairman Powell's press conference will be followed closely. The ECB kept rates on hold last week and the market seems to think they are done with the hiking cycle.

Locally we saw some relief from load shedding which would have eased some of the economic pressures. South Africa's inflation came in a bit hotter than expected at 5.4% but still within the band of 3%-6%. The next MPC meeting is on 23 November where it is expected rates will remain unchanged. All eyes will be on Enoch Godongwana as he delivers the Medium-Term Budget Policy Statement (MTBPS) later today (1 November). Without a doubt the best global news coming out of October was the Springboks winning the Rugby World Cup for the fourth time and managing to unite South Africans behind their success. Let's hope some of the positive sentiment continues into the end of the year and 2024.

Macro Environment

A number of market participants have been commenting on the US debt position which has grown fairly rapidly in recent years and whether this is sustainable. For context, the US has always been a geared country based on their strong economy underpinning the servicing of that debt. They currently have a Debt/GDP ratio of just over 120% which is off the Covid high of 130%. Provided the economy continues to grow they can sustain the higher gearing, and they have shown over a number of cycles that they tend to manage this well and react quickly to market conditions. What is worth noting in the higher interest rate environment, especially considering the higher for longer rhetoric, is how the interest cost is becoming a bigger burden for the Government. As can be seen from the chart below and how the gold line has seen a steep ramp up in the last year as a result of higher rates. The concern with this if it persists for a long period of time is it is not a productive spend of Government finances and it will put pressure on the deficit which will create long term financing concerns. We do not think there is anything to be concerned about right now, but it is something we are monitoring.

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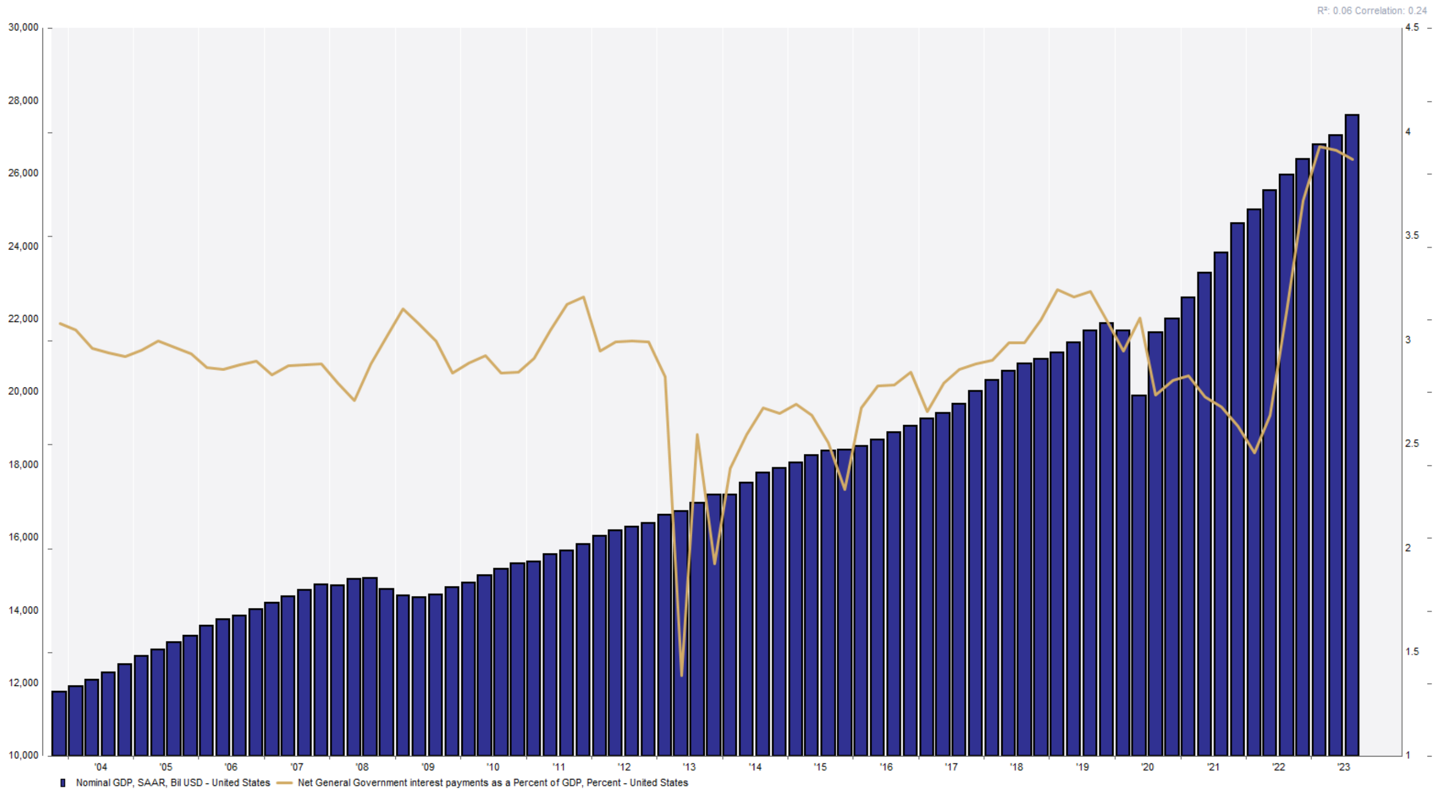
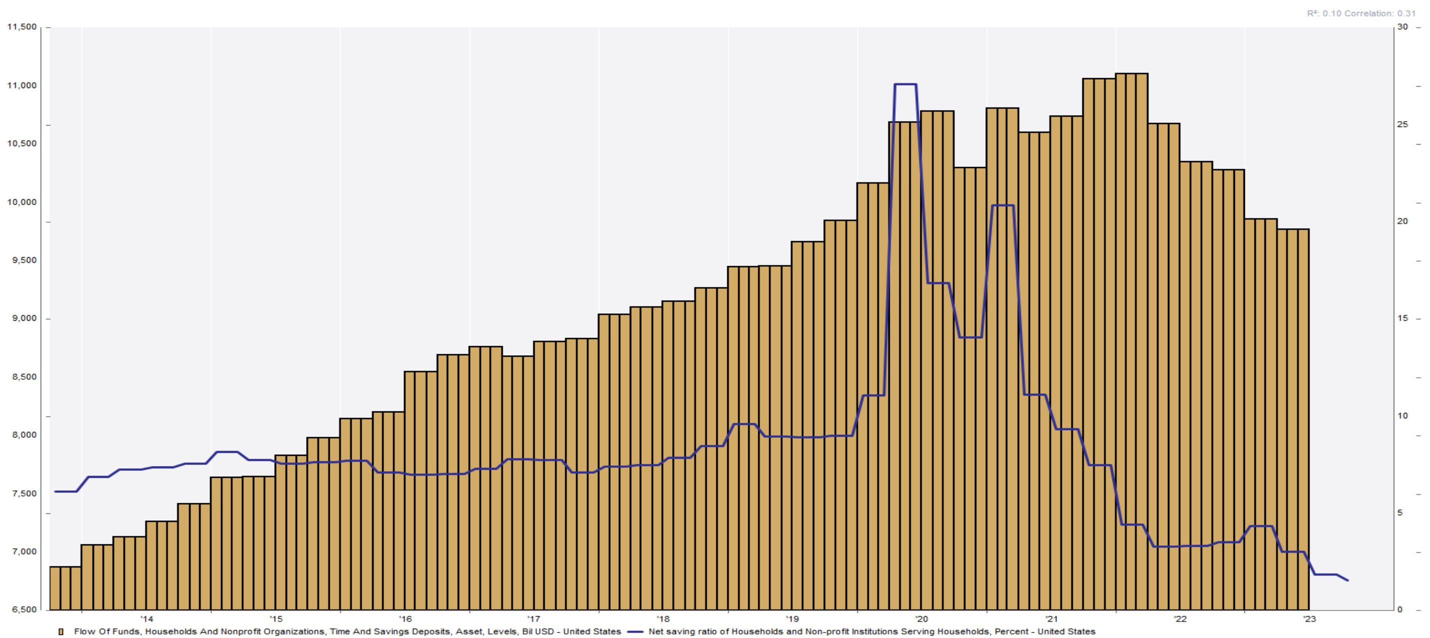


The US consumer has proven far more resilient than many were expecting this year with continued spending throughout 2023. This has added to some of the inflationary pressures; however, we can expect this to ease as the chart below outlines how consumers have been working through their savings balance, indicated by the bars, and their savings ratio is the lowest it has been in a long time (blue line). This is one of the reasons we think the Fed will tread carefully going forward as the consumer will start to feel the pressure.



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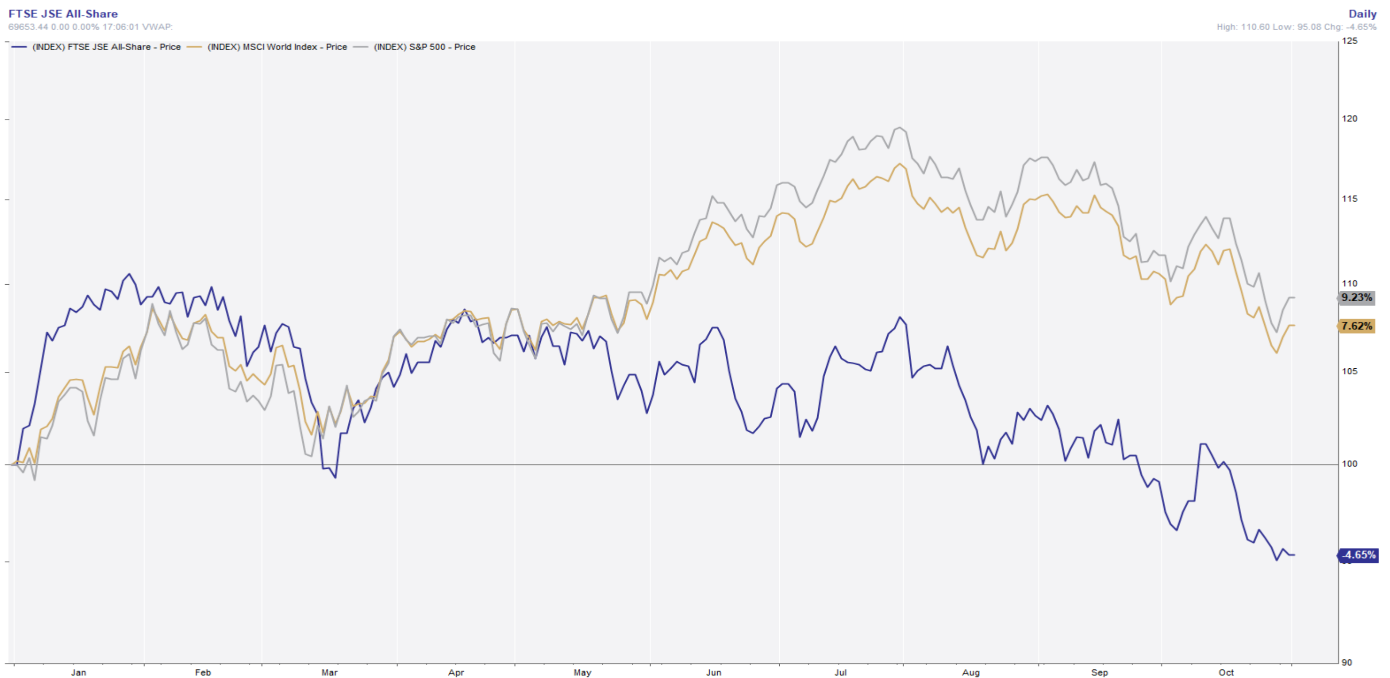
Asset Allocation

The equity allocation of our asset mix remains in line with previous months although the recent pull back has provided an opportunity to top up where some clients are underweight or look to deploy any new money received. We are doing some work on bond positioning as our strategy to date of playing the shorter end of the curve has worked well, although moving a bit further along is presenting an attractive risk-reward profile resulting in our decision to upweight bond allocation. Our structured notes allocation remains in line and continues to perform well especially in the recent volatility.

Market Performance

October has been a weak month for equity markets with pain felt across regions. The S&P500 was down 2.2% for the month while the MSCI World and JSE were down 2.7% and 3.77% respectively. Despite the recent sell off the S&P500 is still up 9.2% YTD and the MSCI World is up 7.6%. Unfortunately, the JSE has struggled this year and to date their performance is down 4.65%.



Equities

Equities have seen a sell-off in October largely driven by the volatility in the bond market and the higher for longer rhetoric causing concerns around valuation and growth. We are in the midst of earnings season, which in general have held up well although there has been some cautious guidance for Q4 and going into 2024 which has impacted markets. According to FactSet, 49% of S&P500 companies have reported Q3 earnings with the blended growth rate at 2.7%, which is on pace for the first earnings growth since 2022. Despite this improvement, analysts have raised concerns about the earnings outlook for 2024. Our view is that it is not surprising that some earnings pressure is expected, based on the macroeconomic environment, but that there is still a positive outlook for a number of our preferred companies who have very strong fundamentals and a view to good growth in 2024.

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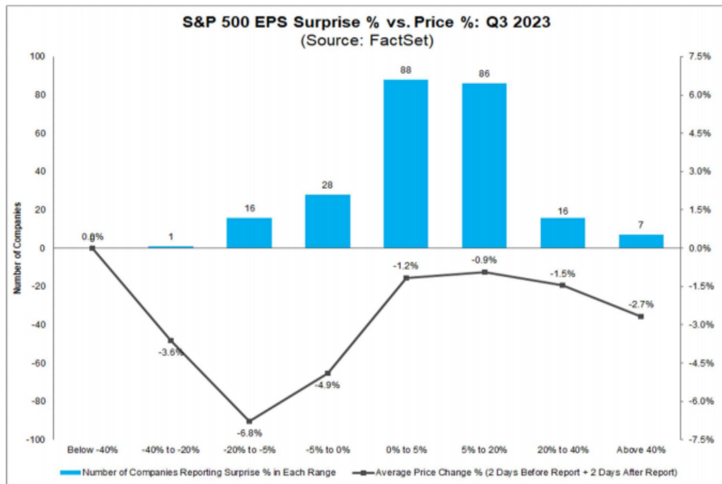
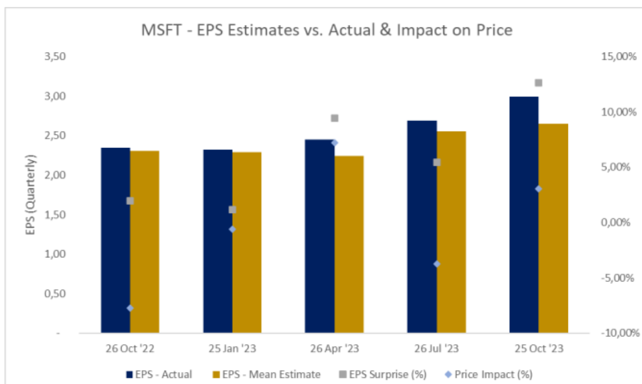
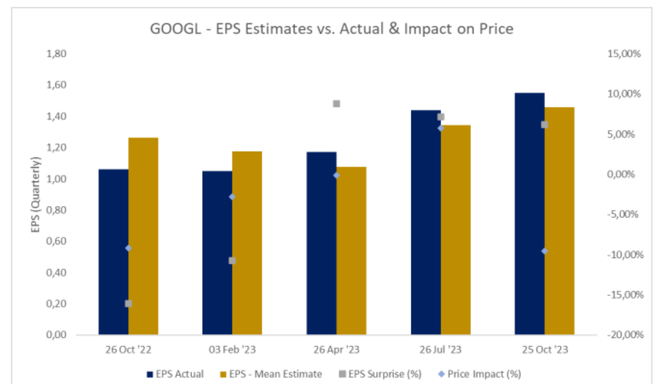
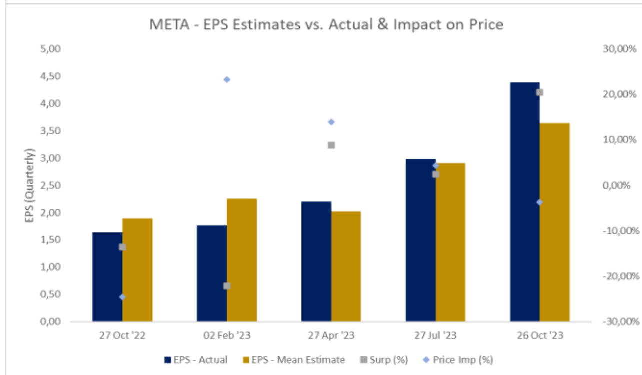


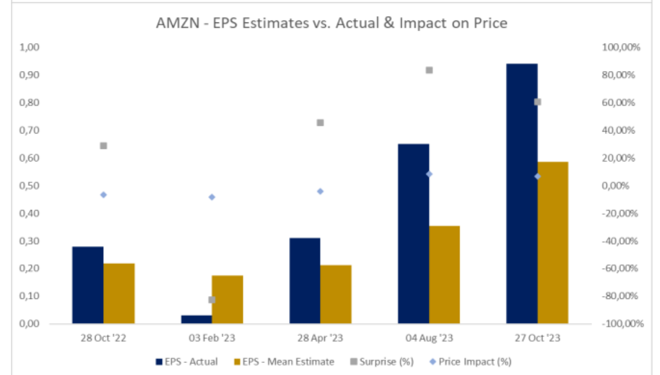
What has been apparent in this earnings season is that earnings misses have been punished more than surprises with the average decline on a miss being 5.5% which is far bigger than the 5-year average of 2.3%. As outlined by the chart on the left over a 2-day period in general the response to results has been negative despite some very positive upside surprises. This is likely a combination of bearish sentiment and the negative macroeconomic overhang and not the fundamental view on the results reported by the company.

It is well known that the main driver of market performance this year has been the Magnificent Seven (Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Meta and Tesla). Their performance has been boosted by the outlook for Artificial Intelligence as a groundbreaking technology and the potential for future earnings. A number of these names have been preferred stocks in DI portfolios and remain so with robust earnings for Q3 and generally a very positive outlook into 2024. The market sold off following some of the results (Apple and Nvidia still to report) with the most notable being a double-digit decline in Google, as concerns around their cloud business slowing down gave some market participants jitters. Our general view is that these companies have very strong fundamentals, generate significant cash flows, and even in a slowing economy are able to generate strong growth. As outlined by the charts below, the companies managed to beat estimates that were already considered fairly lofty which speaks to their very strong performance despite the market reaction.









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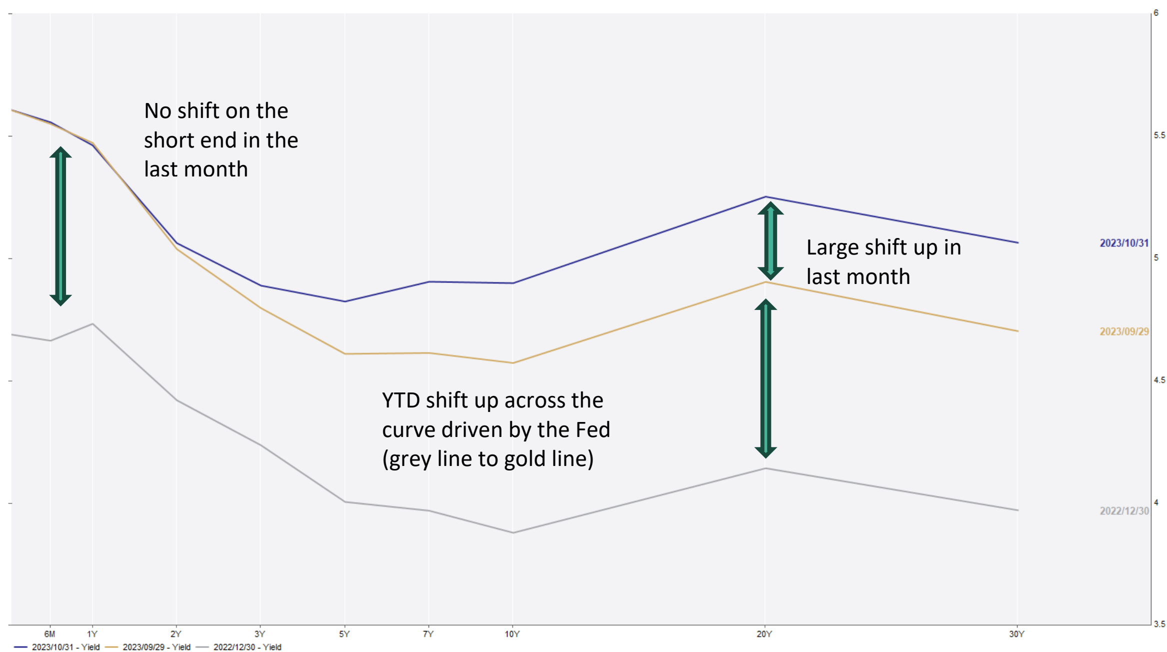
Bonds

From a bond perspective we have been focused on the shorter end of the yield curve in order to benefit from the steep rate hikes and lock in yield for a longer period than what is likely attainable through money market offerings. To date this strategy has worked well. As outlined by the yield curve below, there has been very little movement in the short end of the curve but a significant shift in the longer end which follows the higher for longer rhetoric. This has resulted in poor returns for bond investors who have taken duration risk. With the recent shift, we are looking at moving along the curve as we think the current risk reward is becoming more attractive although the current volatility is likely to remain for longer.

Locally bonds have presented a complicated case as most participants have viewed the bond market presenting attractive value but to date it has not rewarded investors. Inflation is coming down and there are forecasts of interest rate cuts next year which should be good for the bond market, yet the curve has blown out. This is partially due to the volatility in Treasuries in the US, as well as the deterioration in the South African fiscus. The commodity windfall coming out of Covid is gone and our growth has been poor, which does not support tax collection. Pressure on Government spending and a ramp up in debt has seen foreign investors have limited appetite for SA bond risk and in turn our yields have moved up.



Conclusion

October has been another tough month for markets as bearish sentiment has taken hold following the volatility in yields and general uncertainty in the macroeconomic environment. With two more trading months in the year the focus is starting to shift to the outlook for 2024 and in general there are mixed views. At DI we believe the discussion is going to move away from the Fed hikes and inflation to when does the Fed start to cut and what has been the impact on growth. Should the growth remain resilient and the market can see a path to rate cuts then that outcome would be good for risk assets. It is likely that volatility remains for the rest of this year as the market looks for direction following this sell off. We are watching all data points closely especially the outlook from the Fed and will be positioning portfolios accordingly.

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