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Investments: is it time to recalibrate return expectations?

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If you'd invested in growth assets, equity and property in 2021, you'd have been richly rewarded with surprisingly good returns. The investment landscape has changed fundamentally since late last year, however, and as we've seen over the past few weeks, asset class prices have started to reflect these changes. What can investors expect for the remainder of 2022? Do we need to materially reduce our return expectations? Importantly, how do we structure client portfolios in an environment of increased risk and uncertainty?

South African equities returned 29.3% (19.1% in US dollars) over 2021, and global equities returned 22.3% in US dollars. After a dismal 2020, listed property recovered strongly – locally, the asset class returned 36.9% (27.1% in US dollars) and offshore listed property yielded 29%. Given the uncertain economic outlook amid the sustained presence of COVID-19 and the measures introduced to curb the negative medical impact of the virus, these elevated returns were somewhat surprising.

As expected, cash yielded low returns locally – 3.8% in rand terms – and hardly moved the needle in the developed world. South African fixed interest investments gave a credible 8.4% as the attractive yields of local government bonds did enough to offset the negative capital impact of slightly higher yields in the second half of the year. Globally, however, an investment in fixed interest instruments yielded a negative return of 4.7% in US dollar terms.

The outcome for our clients was very positive, as they were invested either uniquely in a South African equity portfolio or in one of our multi-asset portfolios where we were overweight in growth assets and underweight in cash and fixed interest investments. Although we certainly didn't expect growth assets to yield the lofty returns they did, we were always firm in our belief that cash and global fixed interest investments never looked attractive given low global policy rates and, in some cases, negative yields for 10-year government bonds.

Are the drivers still intact?

The question now is whether the same approach is likely to yield similar results in 2022. To provide an informed answer, we need to consider whether the drivers that delivered the 2021 outcome are still intact, or whether they've altered to such an extent that we need to amend our strategy when we consider the construction of client portfolios.

There can be little doubt that the strong performance of growth assets last year was driven mainly by two factors. First, we witnessed artificially low interest rates globally as central bankers provided liquidity to economies that needed stimulus following the short but sharp recession in the second quarter of 2020. Low interest rates boosted economic activity, which in turn provided the backdrop for an unprecedented recovery in company earnings. Equity prices recovered strongly as companies generally produced spectacular earnings growth. The increased liquidity also created funds in the hands of investors who ultimately decided to use the cash to buy assets with a positive story associated with them.

Second, as interest rates were low, investors were prepared to pay a higher earnings multiple for shares, particularly those associated with better growth characteristics. Therefore, we saw massive investment in information technology stocks globally as some of these companies demonstrated that they're correctly positioned for future earnings growth.

Radically changed views

Unfortunately, both these drivers have come under severe pressure in recent weeks. In fact, since late December, analysts have started to change their interest rate outlook radically. From mid-2020, consumer inflation rates have been increasing globally. While central bankers were initially dismissive of the consumer price trend, arguing that inflation may well be transitory in nature and that there was no need for an aggressive monetary policy response to counter inflation, this view has changed significantly over the past few weeks.

In January 2021 in the US, the market expected the first interest rate hike only in 2023, while the current view is that we're likely to see the first increase in March 2022. Over the past week, investors changed their outlook from four hikes of 25 basis points each in 2022 to five. This comes on the back of comments by US Federal Reserve Chairperson Jerome Powell late in January that suggest that this institution is indeed ready and determined to hike rates and curb quantitative easing to bring inflation under control.

Ignoring valuation of asset classes for a moment, the fundamental change in both the interest rate view and the actual action of central bankers should logically have an inverse effect on investor behaviour relative to what we experienced in 2021. Tougher monetary policy measures are likely to reduce the abundance of liquidity that created natural demand for financial assets. There's enough evidence that liquidity in the hands of retail investors inflated the prices of fashionable financial assets, including high-profile US equity names. We're likely to see the tide moving out from that source of demand for financial assets.

Importantly, tougher monetary policy also implies that the slowdown in the momentum of global economic activity is likely to put a dampener on the spectacular growth in company earnings of late. Finally, with interest rates at higher levels, the rating of shares can hardly go higher. The natural conclusion is that we expect materially lower returns for both equities and property in the evolving cycle.

Bear market for equities?

With reduced expectations, the obvious question is whether we expect a bear market for equities to follow. This is certainly not our base case. Equity prices are not extraordinarily expensive relative to fixed interest assets. Nor are we predicting a recession. Economic growth rates are only predicted to lose momentum, not to slump into recession. Of course, the big risk would be if central banks hike interest rates more than market expectations, or overreact to sustained inflation numbers.

We commented in 2021 that we had observed an unsustainable disparity in the valuation of the different financial sectors within equities as an asset class. In the US, high-flying information technology shares enjoyed very high valuations while other sectors still displayed good prospective returns.

However, since mid-December last year, when investors started to change their views on the interest rate outlook, the rotation from these expensive shares into forgotten shares or sectors has been very tangible. We therefore believe that we need to employ a 'granular' approach in equity selection, where we have to position our client portfolios to reflect this change rather than to think of equities as an 'homogeneous' asset class.

A more defensive approach

Our global equity positioning is already in line with this changed view, and in our South African equity portfolios, our selection also favours a more defensive approach. For example, we have a material exposure to British American Tobacco – a call that didn't work for client portfolios for most of 2021, but which has started to add value since mid-December when investors started to 'buy' the view of an altered investment landscape.

We also find value in local banks, and added to the sector throughout 2021. This decision has worked well, but we believe that the sector still offers value. Finally, we continue to hold a substantial weight in Naspers/Prosus. Chinese shares came under severe pressure last year as policy changes in that country scared global investors. In our view, the sell-off is overdone and the biggest asset in Naspers/Prosus – Tencent – is cheap enough to justify our investment in this group of companies.

Despite the increase in global bond yields, this asset class still offers underwhelming medium-term return prospects. However, locally, the yields largely discount the risks associated with the precarious South African fiscal situation. We therefore prefer local long bonds to local cash.

In conclusion, the investment landscape has changed fundamentally since late last year, and asset prices have started to reflect these changes. In our view, this may be merely the start of a broader transition, and investors need to understand that the risks have increased. The macro environment is indeed delicately poised, and for this reason, we advise that investors reduce their return expectations for the foreseeable future. We do believe, however, that our client portfolios are appropriately structured for the increased uncertainty, without sacrificing the ability to deliver inflation-beating returns through the cycle.

Glacier Research would like to thank Alwyn van der Merwe for his contribution to this week's *Funds on Friday*.

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Alwyn has over 25 years' experience in the asset management industry and is well known for his success in managing institutional and private client portfolios. He has a BCom, an Honours in Economics and an MBA from the University of Stellenbosch.

As Director of Investments since 2007, Alwyn van der Merwe has been key in formulating a practical investment philosophy for Sanlam Private Wealth. He is responsible for the implementation of investment research and the investment process, as well as the performance of investment portfolios. He works closely with a core team of talented, in-house investment analysts, and a team of expert portfolio managers to ensure private client portfolio performance in line with risk appetite.