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Attractive opportunities in the current market environment

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Attractive opportunities are the reward for those who can navigate the fear and uncertainty

The world is beset by significant uncertainty that clouds the near-term outlook, including rampant inflation, fears of a looming recession and growing geopolitical risk. The knee-jerk reaction is to retreat to safe assets in an attempt to preserve capital until the storm passes. We believe that investors should look past the noise of the simple narratives and take a longer-term view based on more enduring factors. Some assets that historically acted as safe havens could in fact amplify risk over the next few years. Investors that maintain and build exposure to carefully selected equities are likely to be well rewarded for weathering the expected near-term volatility.

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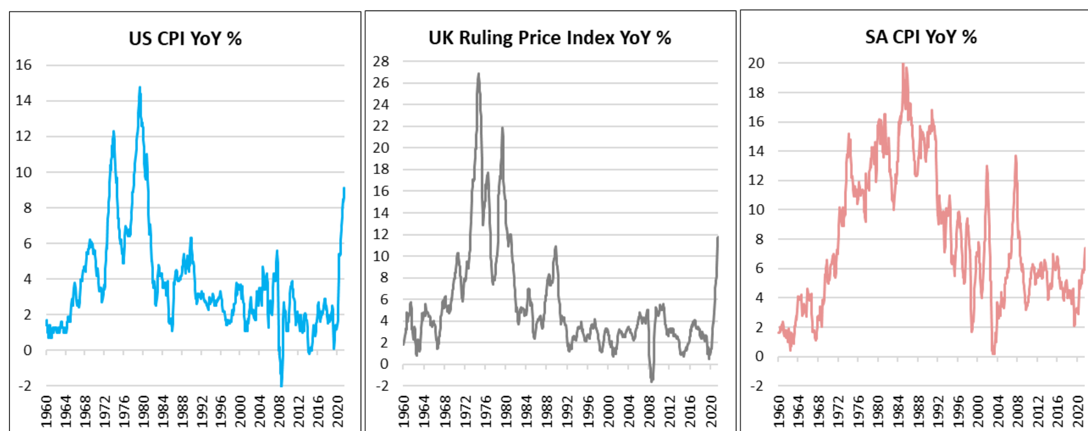
Inflation is back

Figure 1: 60 years of inflation rates: US, UK, & SA



Source: Bloomberg

Inflation in the US, UK and Europe is back at levels last seen in the early 1980s and 1970s. Many other markets, including SA, are also experiencing elevated inflation, although SA's rate is below that of the US, UK and Western Europe, a rare event last seen in 2003/4 and before that, in the 1970s. However, there is a world of difference between how markets are pricing the future inflation risk in different economies. Even if inflation stays elevated, a holder of SA government bonds will still make attractive real returns. In other words, inflation is priced to get worse in SA. Contrast that with developed markets. Here, bond pricing assumes inflation is rapidly brought to heel.

Figure 2: Inflation and bond yields at the end of June

Rates as at end June 2022	US	UK	SA
Inflation	9.1%	11.8%	7.4%
Long Bond Yield	3.0%	2.2%	11.0%
Real Bond Yield	-6.1%	-9.6%	3.6%

UK is based on Ruling Price Index

Source: Bloomberg

Confidence that inflation will quickly subside may be misplaced

Developed market yield curves are pricing in a rapid decline in inflation. While the combination of the Federal Reserve's rate hikes' restraining demand and base effects will no doubt temporarily lower inflation, they will do nothing to alleviate the long-term price pressures. These are firstly many years of under-investment in real economy sectors such as energy, materials, and shipping. Current capex levels are too low to satisfy future demand and given the long lead times between new project approval and first production (some eight years for a deep-water oil well and over 12 years for a copper mine, for example) the tight supply side is likely to be with us for many years into the future. While the consensus narrative has been to blame the COVID-19 demand bump and Russian invasion for high commodity prices, in most cases they were just catalysts that exposed the tight markets, not the underlying root cause.

Secondly, the US labour market has tightened dramatically. This has been a slow process since the Global Financial Crisis (GFC) recession in 2008/9, but the reality today is that the unemployed are outnumbered nearly

2 to 1 by available positions (by comparison in October 2009, there were more than six unemployed people for every available position!).

Neither a lack of investment in the real economy or a demographically tight labour market will be solved by temporarily slowing demand through higher interest rates. Once growth resumes, the commodity price and wage pressures will reappear. They will only be solved by substantial new investment and significantly increased productivity, both of which would take many years to make an impact. In addition, the inflation problem is made materially worse by the massive resource requirements needed to invest for an energy transition and the onshoring of many global supply chains.

What this means for SA investors:

As a large commodity exporter with ample labour SA is likely to be a resilient market in this environment.

Comparable historic periods (the 1970s and 2001 to 2011) show our own inflation rate tends to be curtailed by a strong currency.

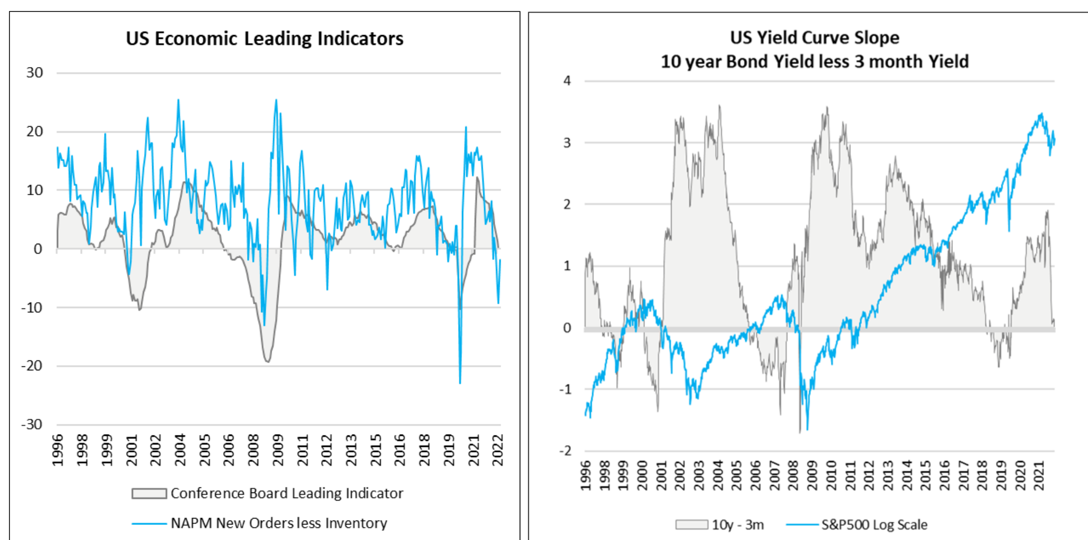
The obvious equity beneficiaries are "real asset" sectors such as materials, energy, shipping, and capital equipment.

However, significant foreign capital flows are likely, meaning lower yields and "SA Inc." domestic companies also performing well. This could make selected SA midcaps the pick of the bunch.

Global recession fears

A huge focus on the likelihood and timing of a US recession has dominated financial media recently. It is clear that the rapid increase in rates in the US has already had an impact on the economy. Leading economic indicators have shown a sharp slowdown in activity, and yield curves have just inverted (longer-dated bonds have lower yields than the short-dated parts of the curve) − also considered an indicator of an approaching recession.

Figure 3: US leading indicators, US yield curve slope with S&P500 Index



Source: Bloomberg

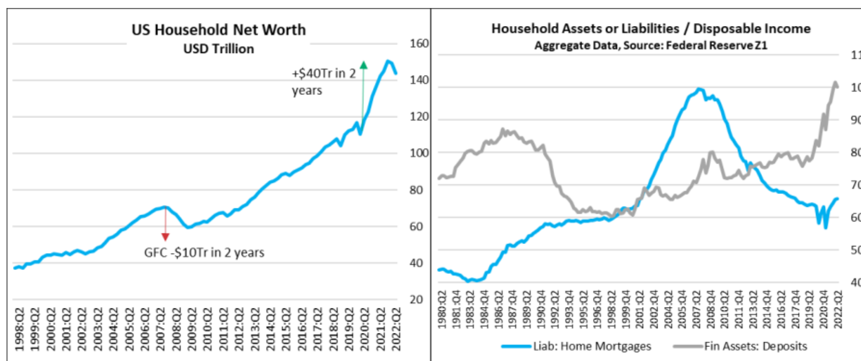
Financial markets are now explicitly pricing in an imminent recession and a pivot from tightening to easing by policymakers. For example, the Fed fund futures curve is showing expectations of nearly 75 basis points of rate cuts starting as soon as early 2023.

Focus on economic resilience, not timing

Markets and economies are cyclical, so it is inevitable that there will be recessionary periods. We do not profess to have any edge or ability to forecast the timing of the next recession, and actually do not see it as a productive endeavour. What is important, however, is evaluating the impact of a variety of macro-economic scenarios, including a recession, on various asset classes generally and on the companies that make up our portfolios, specifically.

Most investors' experience of a recession involves the global lockdown of 2020 and prior to that, the GFC in 2008/9. The GFC was an unusually severe event, where the slowdown in demand triggered severe negative feedback loops from the over-leveraged private sector balance sheets. In fact, the epicentre of the GFC was the global banking sector and extensive household borrowing to fund the speculative purchase of residential property. The aftermath of "balance sheet" recessions like the GFC is a long period of economic stagnation, as the private sector reduces leverage and rebuilds capital.

Figure 4: US Household net worth, cash deposits and mortgage debt



Source: Bloomberg

That process of rebuilding balance sheets took the best part of a decade in the US. However, it is now done. The banking sector currently has ample capital and clean lending books. US households are also in a strong financial position, especially when compared to the pre-GFC period in 2007. Mortgage debt has declined from 100% to 65% of disposable income, and cash deposits are once again much larger than mortgage indebtedness. The US economy is likely to be surprisingly resilient in the face of lower demand.

What this means for SA investors

1. SA equities are generally very attractively valued, and given our inability to time the market, staying invested during periods of unusual uncertainty is of crucial importance for long-term returns.
2. The significant probability that the next recession is mild (more like 2001 than 2008) is not appreciated by the market consensus, and economically sensitive sectors have been aggressively sold off. We believe there are attractive opportunities in equities, including supply-side favoured sectors like materials and energy.
3. It is likely to be the first time most market participants have experienced a stagflationary environment (high inflation and weak growth, last seen in the 1970s) with assets like developed market bonds likely to be sources of risk rather than safe havens.

A new cold war?

The past 20 years can be characterised as a ‘honeymoon period' of steadily increased globalisation and few geopolitical confrontations. This came to an end with the Russian invasion of Ukraine and resultant sanctions. Even more worrying has been the Chinese alignment with Russia and the escalating tension with the US and other democracies as China adopted ‘wolf warrior’ diplomacy. To our mind, China has thrived under leadership best described as smart, pragmatic technocrats. This appears to be over in the Xi Jinping era. Government policy on the role of the private sector domestically, the zero-COVID measures and indeed the explicit alignment with Russia is bewildering.

It appears Xi Jinping’s election for a third term is likely to be just a formality at the Party Congress in October. This raises a significant risk that we are moving into a ‘new cold war’ era. In fact, it could already be upon us. While the direct impact on a South Africa-domiciled investor may be limited, the Russian crisis has shown that even if SA did not participate, the impact of future sanctions could be devastating to share prices of China-exposed businesses.

What this means for SA investors

1. Geopolitical risks are notoriously difficult to handicap, with some scenarios having low probabilities but potentially enormous impact.
2. China, as the second largest global economy and a massive trading partner, is deeply entwined with global businesses. Any cold war-like escalation could be extremely painful.
3. While we would not regard China as ‘uninvestable’, it is appropriate to have a high bar when evaluating opportunities.
4. We believe it is necessary to ensure your portfolios could weather a China crisis, stress-testing both direct impacts from companies with Chinese operations and indirect via upstream supply chains or downstream customers.
5. Understand that the increased defence spending and onshoring of global supply chains that typifies a cold war environment could exacerbate and extend the inflationary pressures described earlier.

Conclusion

Navigating the storm requires us to look through the noise and focus our analytical efforts on more enduring factors such as supply-side constraints and household balance sheets. Financial markets battle to conflate time horizons, with the consensus invariably focusing on the near-term prospects to the exclusion of more nuanced longer-term ones. This creates attractive opportunities.

What does this mean economically?

- The next US recession, whenever it happens, is likely to be mild (more like 2001 than 2008).
- Economically exposed sectors may already be pricing this in.
- A rapid recovery is likely.
- As demand recovers, growth will surprise and inflationary pressures will re-emerge – the secular stagnation is over.

What does this mean for SA?

- Commodity-exporting emerging markets are likely to do well in this environment.
- A strong emerging market cycle similar to the period from 2001 to 2011 is a possible scenario.
- Local investors ‘know too much' to get bullish. It takes foreign capital flows to ignite a rerating.
- Investors are likely to be well rewarded for taking a longer view across multiple local asset classes.
- It’s an attractive environment for commodity exporters but tempered by China uncertainty and potentially a strong rand.
- Domestic SA could shine, with a stable currency, lower rates and bond yields, leading to strong SA Inc. performances.

Glacier Research would like to thank Kevin Cousins for his contribution to this week's *Funds on Friday*

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Kevin is the head of Research and has over 25 years' experience in investment management. Kevin joined PSG Asset Management as an investment analyst in 2015. Prior to PSG, he worked at BoE Asset Management from 1993 to 2002, where he co-founded Lauriston Capital, a specialist hedge fund manager. He then worked as part of the hedge fund management team at Brait (now called Matrix Fund Managers).