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How to be a winner in a volatile market

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The world has become increasingly complex and sophisticated, where technology has amplified access to information and news. Think about it, a simple tweet from Elon Musk can send shock waves through the stock market, and we often overlook or underestimate the power of understanding the basics.

2023 was quite the ride, with sticky inflation, substantial monetary tightening, geopolitical tensions, and lingering recession concerns. Despite the chaos, markets stood firm, and most asset classes outperformed expectations, both locally and globally. This sets the stage for uncertainty and hope as we look ahead to what 2024 may bring. Amidst all the noise in the financial markets, the key drivers of asset class performances are the fundamentals that often get overshadowed. In his latest book, "Same as Ever," Morgan Housel sheds light on a valuable perspective. Instead of obsessing over what the economy will be doing in a decade, there's more wisdom in asking what will remain the same a decade or even a hundred years from now.

As we kick off the new year, perhaps it's wise to hit ‘pause’ and reacquaint ourselves with these fundamentals Let's remember the timeless advice of Benjamin Franklin: "An investment in knowledge pays the best interest."

This article dives into the fundamental factors and drivers influencing asset class performances.

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We know that different asset classes behave in distinct ways during various economic cycles. Therefore, investors will likely tweak their portfolios over time to align with changing circumstances and expectations. This adaptability involves making assumptions about how individual assets will perform in various stages of the economic cycle. The essence of this approach lies in investors discounting the economic cycle, leading to the notion that markets are "forward-looking" by at least six months.

Let us start with understanding the economic cycle

The economy and financial markets share a connection, yet they don't always dance to the same tune. Markets frequently fine-tune themselves in anticipation of economic shifts. An economy tends to move through alternating phases of "expansion" and "contraction", which are recurrent and vary in duration and intensity. This is referred to as the economic cycle (aka the business cycle), and it depicts the rise and fall in output (production of goods and services) over time. But is it as straightforward as it seems? Far from it. Now, let's add the complex note of inflation to the melody...

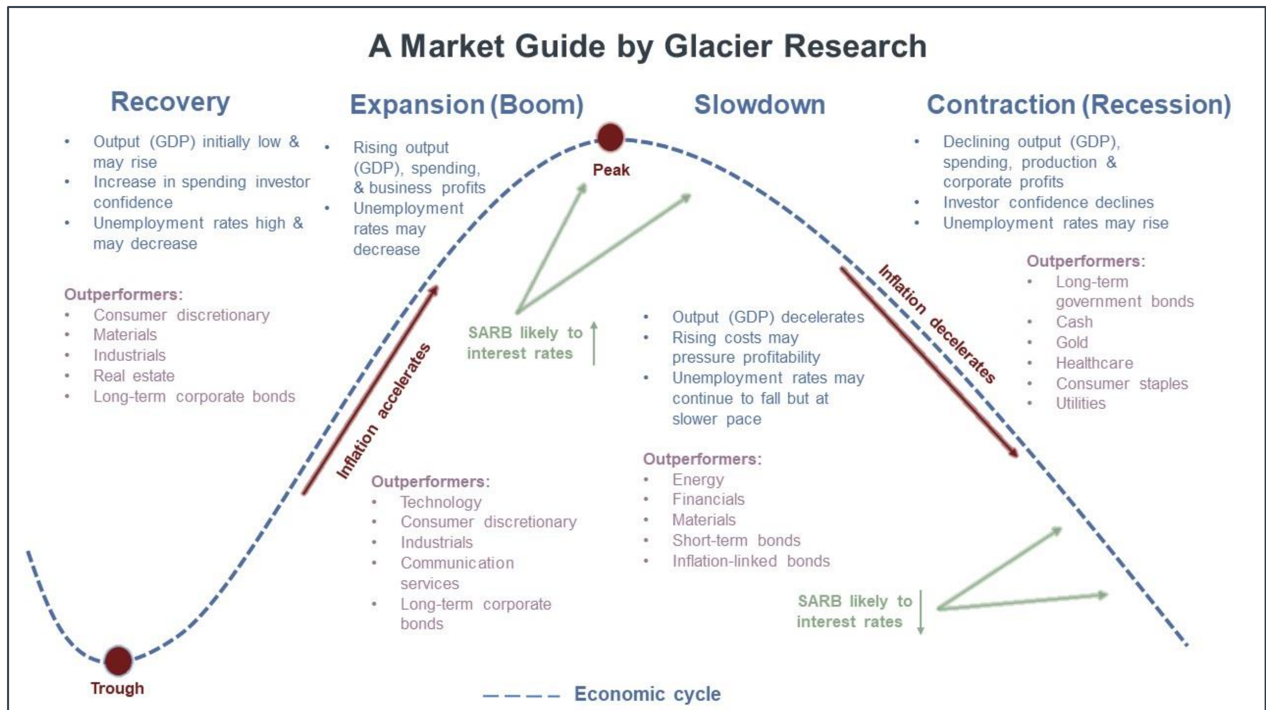
How does inflation impact interest rates and asset prices?

Interwoven throughout the economic cycle is inflation, which indicates an increase in the price levels of goods and services. The challenge is to keep inflation under control, as rampant inflation can devalue a nation's currency. The South African Reserve Bank (SARB) treads this delicate line, aiming for a Goldilocks scenario – not too hot, not too cold – with a targeted inflation rate between 3-6%. The SARB employs a savvy monetary strategy to safeguard the rand's value: hiking interest rates when inflation runs amok and cutting them when it's too timid. This interest rate tango, in turn, orchestrates the movements of asset prices.

When interest rates rise, the investor's script takes a turn. Bonds with shorter durations steal the spotlight, offering stability amid the rate hike. Equities face a trickier plot. With corporate profitability under threat, stocks face a potential derating resulting in a risk-off environment. As risk adverse investors seek refuge in fixed income and alternate assets that can weather the storm, stock prices often decline. Housing affordability takes a hit, slowing the property market's rhythm, leading to hesitation among buyers and struggles for sellers. Meanwhile, cash and money market funds become a lot more attractive.

On the flip side, as interest rates decline, bonds with longer durations take the limelight, promising stability, and potential capital appreciation. The stock market twirls into action, benefiting from lower borrowing costs and a potential rise in corporate profits. Decreasing interest rates breathe life into the housing market, making real estate more appealing. The allure of cash fades as savings accounts and money market funds offer meagre relative yields.

The figure below delves into the interplay of the economic cycle and how asset classes move through the cycle:



Source: Glacier Research, Fidelity Investments: The Business Cycle Approach to Equity Sector Investing 2021

Recovery

Post-recession, the economy rebounds with rising GDP, increased investor confidence, and boosted consumer spending. This normally propels the stock market into a bull phase, favouring equities over bonds and cash. Cyclical industries tied to consumer discretionary, materials, industrials, and real estate thrive in a low-interest rate environment, normally taking the lead. Initial moderate inflation tends to benefit long-dated corporate bonds, while holding cash becomes less attractive as investors seek better returns.

Expansion

Economic activity flourishes, boosting GDP, employment, and business profits. Equities usually outperform, while bonds and cash yield lower returns. Thriving sectors include consumer discretionary, industrials, materials, communication services, and technology. Commercial real estate may benefit from growing business activities. Long-dated corporate bonds, especially those with strong credit ratings, may excel due to improved economic conditions.

Slowdown

Economic activity peaks, while GDP decelerates and rising input costs place pressure on corporate profitability. Inflation concerns may prompt central banks to implement interest rate hikes. Sectors like financials may benefit. The energy and materials sectors may continue their growth amid concerns of potential real estate overvaluation. Short-dated and inflation-linked bonds tend to outperform, providing protection against inflation.

Recession

Economic activity declines, resulting in a decline in GDP growth (or negative GDP), consumer spending, corporate profits, and employment. Equities may struggle, and non-cyclical sectors like consumer staples, utilities, and healthcare may show some resilience. Investors turn risk-averse, favouring safer assets such as cash, gold, and long-dated government bonds. Property may underperform due to reduced demand, high mortgage rates and overall economic uncertainty and instability. Central banks in turn look to cut interest rate cuts, to stimulate economic activity in support of financial markets while still considering inflation rates.

How to be a winner

Fund managers need to have a view of economic cycles to anticipate market fluctuations and position their portfolios accordingly. Dedicated to providing valuable insights for informed investment decisions, the Glacier Research team collates the Glacier Bull and Bear Report, which summarizes eight fund managers' expectations for different asset classes, market performance, currency levels, and global trends over a 12-month period. Essentially, it's a guide to understanding where these managers see us in the market cycles and how they're strategically managing portfolios.

To be a winner, choosing the right fund manager is essential. Beyond their skills and expertise, fund managers offer unique perspectives, philosophies, and management styles that unveil their views in a continually evolving financial landscape. When building your portfolio, the Glacier Research Shopping List offers a curated selection of diverse fund managers, each with unique philosophies and investment styles.

In an upcoming article, we'll explore the captivating realm of fund management styles and philosophies, observing how they adapt throughout the economic cycle. The synergy of diverse perspectives, styles, and expertise of these managers adds depth and resilience to the fund choices proudly featured on our shopping list.

Glacier Research would like to thank Teneille Troskie for contributing to this week's *Funds on Friday.*

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In 2018, Teneille began her journey with Glacier as a product support consultant in the Product Development team, joining through the Sanlam Graduate Programme. In January 2021, she transitioned to the Glacier Invest team, taking on the role of an investment solutions consultant to later join the Glacier Research team in March 2022, as a junior research and investment analyst.

Her academic achievements include a Bachelor of Commerce degree in Business Management and Economics obtained in April 2017, followed by the completion of an Honours degree in Advanced Investments and Finance in December of the same year, both from Nelson Mandela University. Complementing her qualifications, Teneille has successfully passed the RE5 Regulatory Examination.