INTUITION
2 DECEMBER 2022

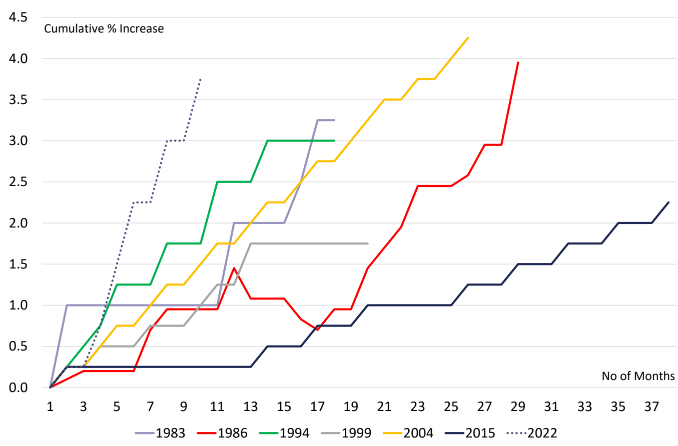
2023: RIP (Recession, inflation, or prosperity?)

It is hard to believe that we are already into December. Another year is about to be consigned to history. Consequently, we are currently hosting the last of our Insight seminars for the year which has covered the outlook for 2023. The focus this year has been on inflation, and the aggressive response thereto from central banks. Higher interest rates are, in turn, raising concerns that the global economy will slip into recession in 2023. There is certainly little doubt that the global engine is slowing down and GDP growth will moderate next year. What is far less certain is whether a recession will actually materialize. Furthermore, while macro conditions are important, we explain the benefit of investing in high quality companies and why you should think twice before selling your investments because of recessionary fears.

Michael Porter

The starting point for analysing what might occur in 2023 is to understand how and why we find ourselves in the current situation. The focus this year has all been about rampant inflation, created by an incredible confluence of factors. Covid policies, supply chain issues, chip shortages, the Great Resignation, and the Russian conflict – to name but a few – are just some of the factors that have conspired to push inflation to its highest level since the early 1980s. Initially slow to respond, central banks soon realised that they were behind the curve and have certainly made up for it.

PACE OF US RATE INCREASES



Interest rates have risen by 3.75% in the US over the past 8 months, and the rising cycle is not yet over. This pace of tightening is unprecedented in living memory.

SPEED READ

- **2022 has been all about rampant inflation and central banks' response thereto. Interest rates are at their highest level since the Great Financial Crisis of 2008/9. Furthermore, they have risen at their fastest pace in living memory.**
- **Higher interest rates are depressing economic activity and raising concerns about a global recession in 2023. There is ample evidence to suggest that the global engine is slowing down.**
- **However, a recession is far from a forgone conclusion. Moderating inflation is already setting the base for the start of a rate-cutting cycle.**
- **We use this opportunity to highlight the dislocation between GDP growth and market performance. Running for the hills could be a big mistake.**

Consequently, interest rates have risen – and risen fast. By way of example, interest rates in the US have risen by 3.75% over the past 8 months, and will probably rise by a further 1% before the cycle comes to an end. An increase of almost 5% within 12 months is unprecedented.

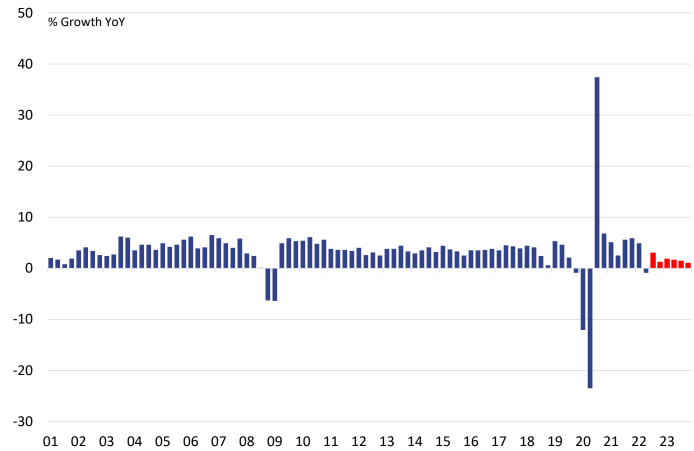
The primary consequence of higher US interest rates has been a strong dollar, and correspondingly, weak currencies elsewhere. If we take SA as an example, a weaker rand, coupled with higher energy costs (oil), has caused our own inflation rate to spike, which in turn has prompted the SARB to raise our interest rates, despite weak growth and persistent loadshedding. That is how conditions in the US are transmitted around the world.

In looking ahead to 2023, the first question that comes to mind is whether inflation will be successfully tamed, as this in turn will influence global interest rate policy. The good news is that there is ample evidence that inflation in America has already peaked, and is expected to fall steadily over the next nine months. Importantly, the decline in inflation will be broad-based and driven by many of the factors that caused it to spike in the first place - housing, medical costs, used cars, and energy and food prices. Indeed, the last data point released in October was better than expected – which has been one of the factors behind the recent global rally in share prices. The implication of lower inflation is that it allows central banks to reassess their policy on interest rates and markets are already looking forward to the start of 2024 and predicting the start of a rate-cutting cycle. That is hugely positive for sentiment.

But given that it takes between 6 -8 months for higher interest rates to impact on the economy, investors are rightly concerned that the pace of tightening has yet to fully manifest itself in the economy, and that despite the ebullient mood, conditions could get tougher before they get better. We would agree with that sentiment, for a few reasons. Firstly, inflation in Europe has yet to peak, so both Europe and the UK are 3 – 6 months behind the US. Interest rates will remain elevated in those jurisdictions for much of 2023. Secondly, China remains an enigma. Chinese growth is slowing steadily, which is understandable given their spectacular growth rate over the past twenty years. However, growth over the past two years has been weighed down by their zero-tolerance approach to Covid, with ongoing lockdowns and restrictions. Six weeks ago, China took steps to relax some of their Covid restrictions, further boosting sentiment and contributing to the recent rally. Unfortunately, China has since experienced a surge in Covid cases – now running at approximately 35,000 new cases a day. This pales into insignificance when measured as a percentage of their population, but it's the highest rate of new cases for months and may well prompt another clampdown. Given that China is the world's second largest economy, actions there continue to reverberate around the world.

Bringing this all together, forecasts for global growth in 2023 are muted. On average, the world economy tends to grow at a rate of 3% - 4% per annum. It has achieved this over the past twenty two years. However, looking ahead, global growth is forecast to moderate to between 1.5% and 2%. This is technically not a recession – that requires two quarters of negative growth – but it is far slower than growth in recent years.

GLOBAL GDP GROWTH



Barring the GFC and Covid, the global economy has grown by 3.5% per annum on average over the past twenty years. The outlook for 2023 is far more muted, as illustrated by the red bars in the chart.

At this point, investors may be concerned about the outlook for 2023 and the impact that it may have on asset values and portfolio performance. If one focuses solely on GDP, then this concern is justified. However, in reality, GDP growth does not have as close a correlation with company profitability as one may think. Giving thought to SA and the "ten lost years" under the Zuma administration, one would assume that corporate profits collapsed over this period. In reality, that is not the case. The chart below highlights the crux of our presentation – that despite weak GDP growth,

CUMULATIVE SA GROWTH

The benefit of investing in dynamic and well-managed companies is that they have the ability to deliver superior earnings growth, far outstripping that of the broader economy.

company profits can still rise. In fact, company profits have grown consistently, and considerably faster, than GDP growth over both the last twenty two and ten year periods.

How can this be? Essentially it comes down to the fact that companies are dynamic and management teams, as stewards of the business, are charged with delivering growth to their shareholders. Successful management teams are looking for new opportunities all the time, resulting in them entering new markets or gaining market share, which results in profit growth ahead of the broader economy. This in turn translates into dividend growth well ahead of GDP growth as well, and invariably well ahead of inflation – the cornerstone of consistent wealth creation.

In our seminar we illustrated this concept through two examples – Microsoft (global perspective) and Afrimat (local perspective). Both these examples illustrate perfectly the power of management to chart their own destiny, regardless of the prevailing economic conditions. Microsoft started in a garage producing MS-DOS, one of the first computer operating systems. Nearly forty years later, it has diversified its products and revenue models significantly, ensuring that it remains relevant to changing trends and capturing the opportunities along the way. So despite a tougher global economy, and pressure from weak PC sales, chip shortages, slowing gaming, and higher staff costs, Microsoft is still able to grow its revenues and profits. Furthermore, because it is prudent, has a net cash position (no debt) and is hugely cash generative, they have grown their dividend at 10% per annum over the past 6 years. We see no risk to their dividend at all over the next 18 months. In fact, we expect it to keep growing. If we bring this back to the HH investment philosophy – if you're living off the dividend, then your investment and income stream is 100% secure. Volatility in the share price, which will change with sentiment, has no impact on you.

To conclude, we must include the possibility that we may be wrong! What do I mean? If there is a recession in 2023, it will be one of the most well-flagged recessions in history. Everyone is expecting a recession so behaviours are already being adjusted. This recession will come with none of the usual excesses – bloated corporates, over-stretched consumers with too much debt. This recession, if there is one, will be caused by higher interest rates and those alone.

We have to remember that markets are forward looking. Investors are discounting conditions 12 – 18 months hence and reflecting those conditions in share prices today. By way of example, let us focus on market activity over the past 8 weeks. At the end of September, global markets were at their low point for the year. This was driven by inflationary concerns, weak growth in China, and political chaos in the UK. However, all that has changed. Lower inflation data in the US has raised the prospect that we are close to the top of the cycle, the UK has settled (for now) and China has announced changes to its Covid policy and additional stimulus to boost domestic growth. So despite the fact that the US Federal Reserve will still raise interest rates by a further 1% (which we know), the market has rallied, because markets are looking through the peak in 2023 and seeing a change in circumstance by early 2024. Sentiment has changed.

In conclusion, we reiterate our long-held view that trying to time the markets is probably one of the worst decisions you can make. By the time News24 reports that global economic conditions are improving, markets will have already rallied significantly. Rather, the focus should be on investing in good companies, with superior management that can withstand near-term pressures. In so doing, you will continue to reap the benefit of steady dividend flow, and be well positioned to benefit from the upside as sentiment turns more positive.

Companies such as Afrimat are not standing still. They are innnovating and creating value, despite tough times.

The world and financial markets have lurched from one crisis to the next over the past few years.

Will 2023 be any different?

Join us as we look ahead to what the new year may hold.

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Topic: **The World in 2023**

Natal Midlands	
Date:	24th of November 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	6th of December 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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