INTUITION
3 FEBRUARY 2023

Strong out of the blocks

Despite some weakness in the last few days of the month, markets globally have started the year at a blistering pace. Locally, the All Share Capped Index has delivered a return of 7% for January. That would be a decent annual return, yet it has come in the space of just a few weeks. Offshore, the performance has been just as impressive. This article explores the reasons behind the rally and whether it can last.

Michael Porter

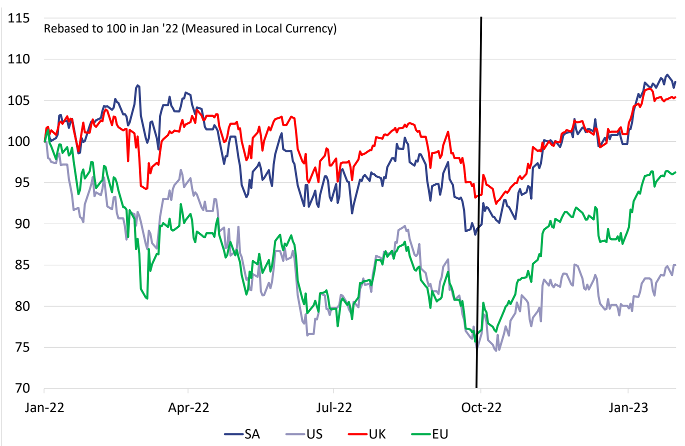
We all know that markets ebb and flow, but like a spring tide, sometimes the ebb and flow can be stronger or faster than expected. Last year was a tough year for markets globally. What started off as a promising year based on a continued recovery from the Pandemic quickly turned into a nightmare as Russia invaded Ukraine, thereby adding fuel to the nascent inflationary fire. The consequence was higher energy bills, higher interest rates, pressure on consumer spending and fears of an imminent recession. In addition, China, the world's second-largest economy, was stuck in a time warp of strict Covid compliance that saw its own economy grow at the slowest pace in decades.

SPEED READ

- **Global markets have started the year on the front foot, chalking up impressive returns.**
- **This has been driven by three factors: falling inflation, China's u-turn on its zero Covid policy, and a mild European winter.**
- **Invariably markets may have run ahead of themselves. Nothing goes up in a straight line!**
- **But the last few months highlight that markets can rally when you least expect it. So, avoid the urge to be too defensive.**

As would be expected, these are not ideal conditions for financial markets. 2022 has been described as the toughest year since the Global Financial Crisis in 2008 for investors – partly because almost all mainstream asset classes came under pressure – be it equities, property, or fixed income. Give or take a week or two, most equity markets reached their lowest point at the end of September last year, when the UK suffered its crisis of credibility. That proved to be a turning point for markets, which rallied hard over the last quarter of the year, with the momentum continuing into 2023.

PERFORMANCE OF MAJOR EQUITY INDICES



Globally, equities declined steadily over the first nine months of 2022, but have since recovered some of their composure. Local equities have performed significantly better than their global peers.

What has changed? Headlines and news channels would suggest not much. Why then are markets so excited? The rally can be ascribed to three factors:

1. Falling inflation. If anything, 2022 will be remembered as the year in which inflation once again came to the fore. After years of slumber, the dragon arose, breathing fire. The US inflation rate troughed at 0.3% in April 2020 during Covid. Two years later, prices were rising at 9.1% p.a., the fastest pace since the early 1980s. Consequently, interest rates rose fast as well. However, we all know that the inflation rate measures the rate at which prices are rising. A slower inflation rate doesn't mean that prices are falling, just that they are rising at a slower pace. Inflation in the US seems to have peaked

in June last year and has since declined steadily – now at "just" 6.5%. The point is that inflation has declined faster than expected, opening the way for positive revisions to interest rate expectations. This has been reinforced by a change in tone from the US Federal Reserve, which acknowledges that a slowdown in rate increases is warranted to allow the impact of past rate hikes to manifest. Markets have interpreted this to mean that the US is close to the top of its interest rate cycle. And remember that the US stands at the centre of the financial world. A top there would give respite to countries everywhere, including SA.

2. China's about turn on Covid. In the second issue of the year (dated 13 January) Nick delved in detail into the issues affecting China and how they were changing. Whilst the rest of the world has moved on from Covid, China has stubbornly stuck to its "Zero Covid" policy. That came to a head during the FIFA World Cup that was held in Qatar in December. Through social media clips, Chinese citizens got a glimpse of normality – global citizens were enjoying themselves. Why then were they still subject to such harsh treatment? Protests unfolded, spurring the government to finally relent. Yes, cases and deaths have soared, but they are already past their peak. Furthermore, economic activity is already gaining momentum, despite the surge in cases. The change in China has global ramifications. At a time when the world is facing slowing growth, China returning to "normal" is a welcome shot in the arm for the global economy.
3. A mild winter. If you had kept an eye on the news over December, you might question what I mean by a mild winter. After all, the US and Canada suffered ten days of artic temperatures and the UK was white with snow in early December. Not a common sight. Yet this winter has been mild, by historic standards and that has provided Europe with the crucial break it needed. A harsh winter would have strained energy supplies, forcing up prices and playing into Putin's hands. Fortunately, fate was on Europe's side. Temperatures were mild so energy prices (especially gas) have plummeted. The stockpiles remain intact. This has prompted analysts to raise their forecasts for European growth, which is now (apart from the UK) expected to avoid recession this year.

NATURAL GAS PRICE

Having been stable for a decade or more, gas prices surged in 2022 following the invasion of Ukraine. But a mild winter has provided the break that Europe needed. Prices are tumbling, relieving pressure on businesses and consumers alike.

Following upgrades to both European and Chinese economic growth, the outlook for the global economy has improved considerably over just a few short weeks. Despite having been in financial markets for almost 30 years, it still amazes me just how quickly the mood can change. As I have already noted, this has prompted a strong rally in global equities. But whereto from here? Can this rally be sustained?

> "Following upgrades to both European and Chinese economic growth, the outlook for the global economy has improved considerably over just a few short weeks."

As is so often the case, markets overreact to both bad and good news. They fall too far, thereby offering attractive returns for those willing to take a countercyclical position. Likewise, they can rally too hard when the news improves – discounting too much good news. In my opinion, the blame can largely be laid at the door of passive investors, who drive the near-term momentum.

Despite the good news, there is reason not to get too carried away. In our opinion, the biggest risk facing markets in 2023 is that inflation does not fall as quickly as anticipated, or rather, that core inflation (including wages) proves to be far stickier than expected. This would alter the outlook for interest rates. Instead of peaking within the next few months as is currently expected, interest rates may actually rise further and the timing of any cut would be pushed well into 2024. That would certainly fuel the bear case for a recession later this year. This is not guaranteed – retrenchments in the US are gaining pace so the labour market may soften – which perversely would be interpreted as "good news".

US CORE AND WAGE INFLATION

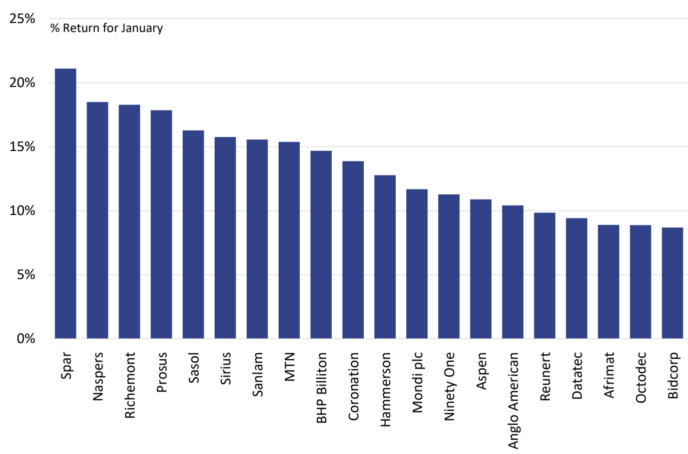
Whilst headline inflation in the US has fallen from 9.1% to 6.5%, wage and core inflation has proved far stickier. There needs to be a meaningful reduction in these metrics before the US Federal Reserve will believe that inflation is back under control.

Closer to home, our woes need little explanation. We have been plunged into extended loadshedding, the consequence of which is a severe reduction in our forecast growth rate. The Reserve Bank cut its estimates for 2023 growth last week from 1.2% to just 0.3%. In addition, PriceWaterhouseCoopers released a research paper, claiming that growth could have been 5% higher last year had it not been for loadshedding. That is the clearest evidence yet of the lost opportunity due to government incompetence.

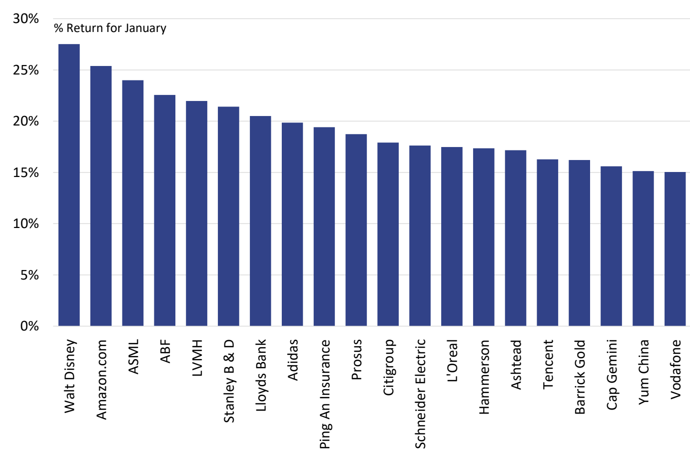
There is no doubt that the rally on the JSE has been fueled by the recovery in Naspers & Prosus, and to a lesser extent, Richemont, thanks to the changes in China. SA bears are quick to point that out. Yet, encouragingly, the rally has been far broader. That is evidenced by the difference in return between the All Share Index (+8.9% for January), and the All Share Capped Swix Index (6.9%) – a mouthful maybe – but the latter caps the weight of large companies at 10%, to better reflect constraints faced by a typical investor. It is the preferred benchmark for the SA market. This suggests that the rally has been broad based, despite the difficult macro conditions. We still remain bullish on SA assets as we believe that the electricity crisis will accelerate reform that will continue to lay the ground for a higher growth rate in years to come. This is certainly not reflected in current valuations.

Nonetheless, the near-term trend would suggest that the market has gotten ahead of itself – both here and abroad - and we would agree. Seasoned investors will know that nothing goes up in a straight line. Expect some ebb and flow in the months ahead. 2023 is not going to be an easy year. But if anything, also learn from the last three months. Markets rally when you are least expecting it and certainly long before the newspapers hint at better times ahead. Being too defensive might seem a sensible strategy in the short term, but it seldom is over a longer period. The best way to cope with uncertain markets is not to be out of the market completely, but rather to ensure that your portfolio consists of high-quality companies that can withstand the tough times, and then deliver exponentially when the mood turn smore positive.

HH LOCAL TOP PERFORMERS



HH OFFSHORE TOP PERFORMERS



These are the top 20 performers in January across HH portfolios. Encouragingly, the companies fall across multiple sectors of the economy, showing that the rally has been broad-based.

The date for our next Insight seminar is shown alongside. The topic will be announced shortly.

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Topic: **TBC**

Natal Midlands	
Date:	Thursday, 16th March 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	Tuesday, 14th March 2023
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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