INTUITION
8 DECEMBER 2023

2024: Lower and lighter?

Christmas is just a few weeks away, which implies the start of a new year as well. As is so often the case, 2023 has dished up its fair share of both predictability and surprises. Unsurprisingly, interest rates have risen to twenty-year highs this year, yet growth has exceeded expectations. The Ukraine war is far from resolved and another regional conflict has broken out, yet fortunately, oil prices have remained muted. China has finally relaxed its Covid-19 policies, yet growth there has been underwhelming. Locally, the level of loadshedding has exploded, yet our economy has held its own. Over the past week we have presented on the Outlook for 2024. That presentation was entitled, "Lighter & Lower?" in reference to whether we might have more light next year (less loadshedding) and lower interest rates. This article summarises that presentation.

Michael Porter

Six months ago, we updated clients on our outlook for the next eighteen months. The key conclusions were that better times hinged upon two factors – namely a reduction in loadshedding and a peak in US interest rates. As we approach the start of 2024, nothing has changed. These two variables still largely underpin the case for local investments for the year ahead.

It does not take much intuition to know that 2023 has been the worst year for loadshedding in our history. At the time of writing, we had experienced 340 days of loadshedding this year. Alternatively, we have only had 12 days without loadshedding over 2023, and eleven of those days were in October. Despite the recent ramp up in loadshedding over the past 3 weeks, there has been a significant improvement as the year has progressed. The first 5 months were characterized by extensive periods of Stage 4 or higher, whereas we have generally experienced Stage 3 or lower in recent months – the odd week notwithstanding.

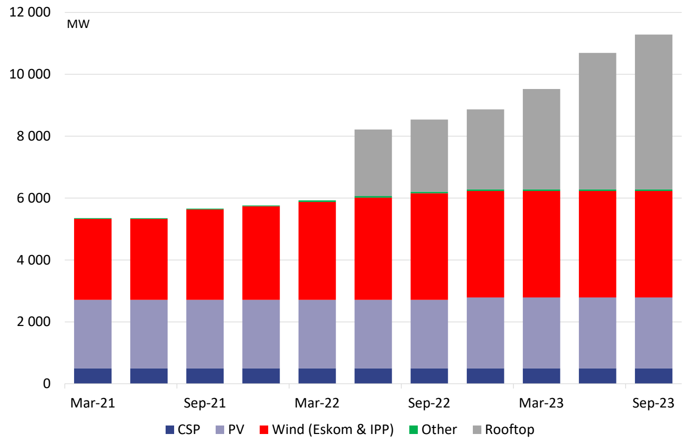
Some of this is due to Eskom's own recovery. In June, they laid out plans to bring all 3 units at Kusile back on stream before the end of the year. That has been achieved, as has the recommissioning of Koeberg Unit 1. Another reason for hope is the significant levels of activity within the transmission network. At present, there are 46 projects underway across the Grid. Twenty-six of these projects will add 1600 kms of new power lines and facilitate the introduction of 15GW of new power generation. Encouragingly, of these twenty-six projects, thirteen are already under construction.

SPEED READ

- **In our June update, we argued that the outlook for 2024 hinged on two factors: an improvement in loadshedding and a peak in US interest rates. Nothing has changed.**
- **Despite the deterioration in loadshedding over the past 10 days, we still believe that 2024 and 2025 will see incremental improvement, driven by private sector investment and ongoing reform.**
- **In the US, inflation is moderating, which is welcome. But the economy is showing signs of strain – evident across numerous indicators. Are we facing a "boil the frog" scenario?**
- **SA assets stand to benefit from a virtuous cycle if the trend in loadshedding and US interest rates unfolds as we expect. This is not priced in, which creates opportunities for investors.**

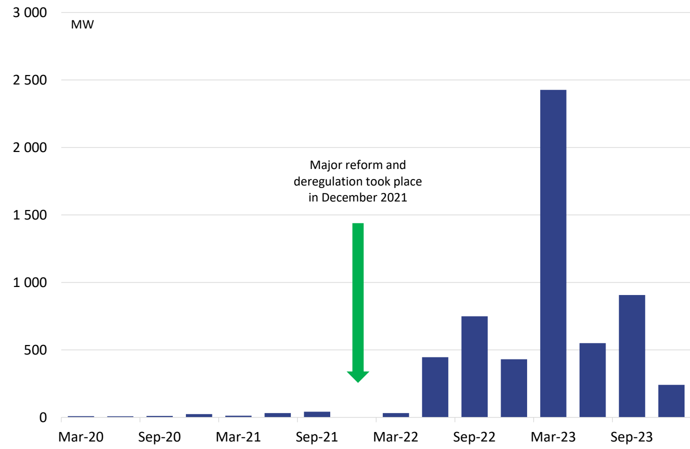
Despite the improvement we have experienced in loadshedding, the real benefit of regulatory reform is still to be felt. Deregulation only happened in December 2021, when the regulations removing the need for a license were finally lifted. Since then, more than 6GW of new projects have been registered with NERSA. However, over the past 3 years, only 600MW of new renewable power has actually been added to the country's generation capacity. The reason is that large projects take time – to finance and build. The bulk of these projects will come on stream in 2024 and 2025,

INSTALLED CAPACITY OF RENEWABLES



SA has 11.3GW od renewable capacity, but much of the new capacity over the past two years has come from rooftop solar installations.

PROJECTS REGISTERED WITH NERSA



Since deregulation in December 2021 more than 6GW of new projects have been registered with NERSA. These will start to come on stream in 2004 and 2025.

which will completely alter our generation capacity. In the meantime, just short of 5.5GW of rooftop solar has been installed, which is alleviating the strain. Standard Bank Securities, in conjunction with reliable Eskom insiders, believe that daytime loadshedding could be a thing of the past by June 2024.

It might seem obvious, but what are the key benefits of a reduction in loadshedding?

1. Companies have been forced to spend billions on mitigation measures, whether its diesel, generators, inverters, or the like. These costs will increasingly fall away, and rooftop solar could also dramatically reduce electricity bills if we experience lower stages. Companies stand to benefit from margin improvement which implies stronger profits.
2. Consumers also stand to benefit. For years, consumers have been forced to reprioritize spending away from nice-to-haves to mitigation measures. That spending can now go back towards more discretionary spending.
3. The national mood stands to benefit enormously, which should manifest itself in rising consumer confidence.
4. Finally, foreign perceptions of SA should improve too. Less loadshedding will signal a change in trajectory that might cause foreign investors to reappraise SA as an investment destination (at least for portfolio investment.)

Let me now focus on the second key variable – US interest rates. Since our last presentation, US inflation has trended steadily lower. Headline inflation is now just above 3%, whilst core inflation is 4%. This is still above the Federal Reserve's target of 2%, but a far cry from 7% reached earlier this year. At the same time, inflation expectations continue to moderate, further reinforcing the downward trend.

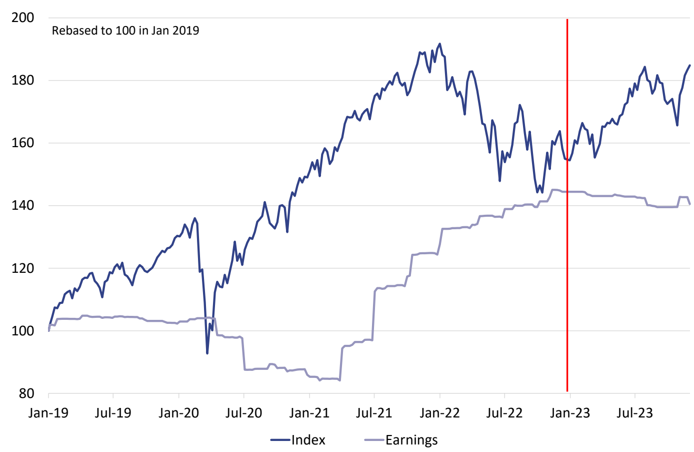
> "Unfortunately, there are numerous signals that the US economy is starting to weaken – that the impact of higher interest rates is finally making itself felt. "

Unfortunately, there are numerous signals that the US economy is starting to weaken – that the impact of higher interest rates is finally making itself felt. Numerous indicators across the economy indicate that growth is slowing - including the labour market. The unemployment rate troughed at 3.4%. Now its 4%. Other indicators – such as the number of jobs being advertised and the number of people being retrenched – are also deteriorating. It was therefore somewhat of a surprise that GDP growth for Q3 2023 was 5.2% - the strongest quarter of growth since 2014 if we strip out the quarters in 2021 that were distorted by the Pandemic. Surely that undermines my argument! A deeper dive into that statistic shows that growth was driven by higher government spending and a build-up of inventories – both of which are unsustainable. On the contrary, the outlook for US economic growth in 2024 is extremely muted – 0.5% at best.

The chart below is worth noting. It shows the performance of the S&P 500 Index and the associated level of profits, rebased to 100 in January 2019. Over the past five years, the Index has returned 80% - handsome by any measure.

But profits have only grown by 40% over the same period. The red vertical line indicates the start of 2023. Over the last 12 months, share prices have rallied hard, yet profits have been stagnant. Investors should ask themselves whether profits can grow strongly enough to justify higher share prices when economic growth is forecast to slow? We do not think so. We believe that the US is at risk of a “boil the frog” scenario. Economic conditions have been deteriorating for some time but have been masked by strong employment due to Covid distortions. Cracks are now showing. The frog thinks he is enjoying a warm bath but will only realise too late that in fact he is turning pink! The risk is that the Federal Reserve will be slow to cut interest rates, thereby exacerbating the slowdown. However, that makes us increasingly confident that US interest rates have peaked. That is a key driver for emerging markets assets in general, and South African investments in particular.

S&P 500: RETURNS VS EARNINGS



The S&P 500 has returned 80% over the past 5 years, yet profits have only risen by 40% over the same period. That implies higher valuation Over the past year, returns have been good, yet profits stagnant. Something must give.

The combination of lower US rates and an improvement in loadshedding should cause the Rand to strengthen, in turn causing inflation to fall and thus giving our Reserve Bank scope to cut local interest rates. That will underpin a modest consumer recovery that should gain momentum as the year progresses. Counterintuitively, unemployment is improving in SA, albeit off a weak base, which is also adding to discretionary spending.

There is little doubt that the key reason why SA assets have performed so poorly for the past 6 years has been sentiment, reflected in valuations falling to multi-year lows. Investors might find this hard to believe but SA companies have grown their profits fourfold since 2000, versus only threefold for all other companies (and countries) represented in MSCI’s Emerging Market Index. If profit growth is so much stronger here, why do SA shares trade at a discount to those same peers? The only answer is sentiment – a concern that the future holds no promise. That has never proved to be the case, and we do not think it applies now either.

Apart from these two overarching drivers, we should be cognizant of a few other factors next year. Positive surprises could come from stronger Chinese growth after a very lacklustre year and higher precious metals prices, especially PGMs. The biggest risk for 2024, in our opinion, comes from renewed global turmoil and a resultant spike in oil prices, which will undo the disinflationary trend currently underway. We also cannot forget that next year will be an important election year – in SA, the UK and the US. We think investors would do well to take sensational headlines from whence they come. There is bound to be lots of electioneering – from all quarters.

In summary, the bad news in SA hasn’t gone away. An incompetent government, crumbling infrastructure and failing SOEs will still be features next year. But we would argue that these are already in the price. (Furthermore, we are somewhat encouraged by the speed with which remedial action has been taken at Transnet in recent weeks.) We are not out of the woods, by any measure. Yet we feel conditions are ripe for some of the good news to outweigh the bad news – good news in the form of falling interest rates, falling fuel prices, reduced loadshedding, slightly better GDP growth and accelerating investment into infrastructure. This improvement is coming at a time when valuations are at record lows. That provides the opportunity for solid risk-adjusted returns from local investors. Having been patient for 5 years, 2024 might finally give local investors a reason to cheer.

Merry Christmas & Happy New Year

This will be the final issue of Intuition for this year. The next issue will be published on the 5th January 2024. We wish all our clients a happy and safe Christmas and a healthy and prosperous new year. Please note that as usual, our offices will be closed from midday on Friday 22nd December and will reopen on 2nd January.

Topic:	To Be Announced
Natal Midlands	
Date:	TBC
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	TBC
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	TBC
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

Thank you to all clients who have supported pour Insight presentations this year. Our schedule for 2024 will be published early in the new year.

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CONTACT DETAILS:

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HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za