INTUITION

21 JUNE 2024

Now what? A summary of our mid-year update

It is now three weeks since the election and we have far greater certainty about the future than we did just a week or ten days ago. Our mid-year seminar provides an update on our views for markets, now with this crucial milestone behind us. Given political stability, we reiterate our long-held view that reform is gathering momentum, which in turn should lead to higher GDP growth over the next few years. In addition, we are increasingly confident that listed property is on the cusp of a rally. Globally, however, things are a little more challenging, and we question whether inflation can trend back to 2% given the changes to global geopolitics.

Michael Porter

Our mid-year seminar roadshow kicked off in Johannesburg on the 10th June – bad timing from our point of view given that the format and composition of a new government were far from confirmed. Consequently, we undertook some scenario analysis, only for that initial scenario to be scrapped as the GNU took shape. Our second iteration assigned a 50% probability to a government consisting largely of the ANC, DA and IFP. By the time we had delivered our third event presentation in Somerset West, this probability had risen to 70%. Now we have clarity and believe this is a positive outcome for markets. At worst, its business as usual. At best, there will be greater urgency and accountability within government, which will drive faster growth. Importantly, the reform agenda remains firmly on track. We believe this is positive for both business and consumer confidence.

Over the past two years we have spent much time delving into the reform agenda driven by Operation Vulindlela within the President's Office. This task force set out to achieve 35 reforms, of which 26 have either already been completed or are close to completion. Nine remain outstanding, with two of those well behind schedule. Those relate to reform of the fuel price formula and municipal electricity distribution. These will be tackled in Phase Two.

We might sound like stuck records, but electricity is a valuable case study. Major reforms took place in 2021 but the real game-changer only occurred in December 2022, when the threshold for embedded generation was removed completely. Since then, 22GW of projects have been registered and approved with the "Energy One Stop Shop" office. These projects will start to come on stream from this year onwards.

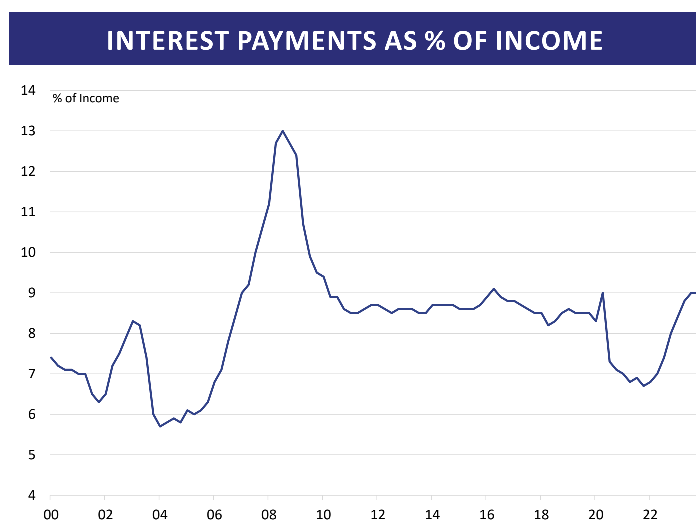
SPEED READ

- **The election is out of the way, Ramaphosa has been elected president and the cabinet is taking shape. SA has avoided a worst-case scenario – again!**
- **Reform continues, and there is every indication that the new GNU will support this initiative. Whilst it takes time to manifest, electricity reforms are bearing fruit.**
- **SA assets are cheap and poised to perform better given a stable government. Listed property is looking equally attractive.**
- **Globally, things are trickier. We do not expect inflation to return to 2%, and believe portfolios need to be positioned accordingly.**

However, equally crucially, last year the private sector seconded 130 corporate CEOs to government to help tackle the issues of electricity, logistics and crime, amongst other things. This initiative is also bearing fruit. Eskom's fleet of power stations is performing at its best level since last 2021. If we add the 6GW of rooftop solar installed over the past three years, as well as the power coming from new renewable projects, it is easier to understand why we have had no loadshedding for almost three months. We are not naïve – bouts of loadshedding will recur – but the benefit of reform made 2-3 years ago is finally manifesting itself in our daily lives. The point is that the benefits of reform take time to materialize, but that shouldn't be interpreted that nothing is happening. Far from it. Significant change is underway at Transnet, facilitated by a far more progressive CEO, Michelle Phillips. We might not see evidence of this

reform for another year, but it is happening. We believe these are crucial factors that will support a revival in business confidence, a precursor to stronger growth.

Whilst the reform agenda is exciting, unfortunately the SA economy is currently experiencing a typical cyclical downturn, driven by higher interest rates and fuel prices, which are sapping disposable income. The chart below shows that interest payments as a percentage of disposable income sit at 9%, the highest level for ten years. Coupled with low growth, this is putting consumers under strain and causing weak GDP growth. Anxiety leading up to the elections caused a further dip in activity, resulting in a weak start to the year. We are confident that growth will accelerate over the remainder of the year, especially if interest rates fall in September as we expect.



On balance, debt levels are not excessive, but higher interest rates are consuming 9% of consumers' income. Combined with high fuel prices, consumers are feeling the pinch.

In positioning portfolios for the next eighteen months, we are focusing on five themes:

1. "The Supported Consumer / Lower Rates". These are companies that will benefit from the continuation of social grants, as well as lower interest rates.
2. "Pockets of Excellence / Rand Hedges". Given the duality of the JSE, there will always be a place for some of our global companies, many of whom are leaders in their fields, and core holdings, in our opinion.
3. "Reform / SA Optimism". These are companies that will benefit from improving sentiment towards SA and that stand to benefit from reform and greater private sector involvement in the economy.
4. "Commodities and inflation hedges". As we will discuss shortly, we believe it is important to have some inflation protection, through commodities and companies with significant pricing power.
5. "Listed Property". We believe that the cogs are falling into place for a sustained improvement in listed property. We are well on this journey – the last factor required is a cut in interest rates. We should only be months away from that. Once rates start to fall, we believe that listed property will pop back onto the radar screens of investors.

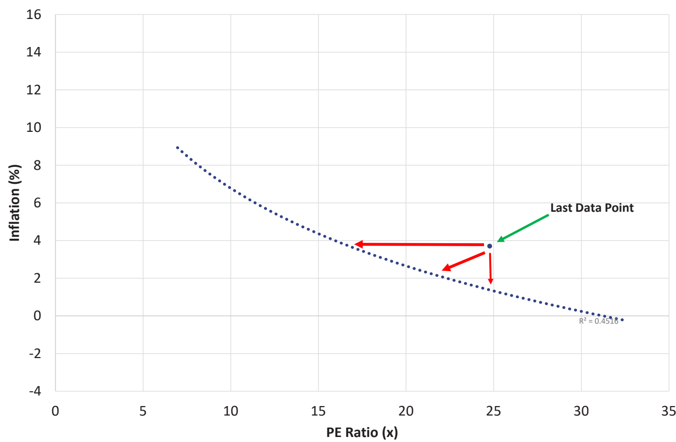
The second half of the presentation focused on global issues. In our opinion, the outlook for global markets is a little trickier. We start by asking whether it is realistic to assume that inflation will trend back to 2% per annum? Over the past 30 years, low inflation was driven by the end of the Cold War, and the ensuing "peace dividend" of globalization and free trade, which saw goods and people move around easily. Those conditions no longer apply. The world is fracturing into different factions. Globalisation is in reverse, with companies now looking for security of supply rather than the cheapest price. This was compounded by Covid, and now war. In addition, after fifteen years of near-zero interest rates, the world is awash with money and debt. Combined, these are not conditions conducive to low inflation. We do not think investors should assume that, going forward, its "business as usual."

Why is the debate around inflation so important? It is because there is a very clear relationship between the level of inflation and the valuation of share prices. The higher the inflation rate, the lower the overall level of valuation for a market. That is intuitive, given that higher inflation implies higher interest rates, which in turn imply lower valuations. Study the chart below. It shows this relationship for the US. At present, valuations are approximately 24x earnings – heady by any measure. In fact, apart from the distortions caused by Covid and the GFC, valuations are at their highest level in twenty years for the US market. If we believe inflation will return to 2%, then the market is correctly valued. However, an inflation rate of 4% would imply a valuation of 16x earnings. US markets are vulnerable to a derating should inflation remain higher for longer.

That does not mean there is not opportunity in global markets. Similar to our stance on local markets, we are building portfolios around 5 key themes, namely:

1. "The Aspirational consumer". Millions of people around the world are benefitting from rising living standards, and this is fuelling aspirational spending.
2. "Digitalisation, Fintech and AI". This will continue to be a strong theme as companies rush to capitalise on the benefits of big data. We caution that investors should be selective though, and vigilant on the valuations in this sector.
3. "Infrastructure and Energy". One of the consequences of AI is the need for more robust energy and electricity infrastructure. Similar to SA, developed countries have underinvested in national grids and other key requirements. Demand for data will fuel investment

US RELATIONSHIP BETWEEN INFLATION & VALUATIONS



There is a clear inverse relationship between inflation and valuations. The higher inflation, the lower valuations. Markets are remarkably sanguine about future inflation, but if inflation proves to be more persistent, then valuations are at risk

into "old economy" industries.

4. "Commodity and inflation hedge". This theme applies globally as well as locally. Investors should have exposure to commodities that offer a hedge against inflation, as well as companies that have pricing power.
5. "EM vs DM and Value vs Growth". The last category captures the debate between investing in developed markets vs emerging markets and value stocks vs growth stocks. A higher inflationary environment generally favours the emerging markets and value categories.

In conclusion, we believe that markets are poised at an interesting inflection point. Locally, our elections are out of the way and a brighter future potentially beckons provided parties can work together. We believe that the outcome (as it stands) is positive for business confidence, further reform and the Rand, which together should underpin faster economic growth over the next two years.

Globally, markets only have eyes for the Federal Reserve and the path of US interest rates. Whilst inflation has moderated, and rates should fall later this year, we caution about assuming that we are heading back to the halcyon days of the past 15 years. Times are changing and portfolios will need to adapt.

SOUTH AFRICAN THEMES AND PORTFOLIO POSITIONING

GLOBAL THEMES AND PORTFOLIO POSITIONING

Our next seminar will be held in September. The topic will be advertised in due course.

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Topic: TBC

Natal Midlands	
Date:	12 September, 2024
Venue:	Christ Church Howick, 23 Mare Street, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	10 September, 2024
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	n/a
Venue:	SSISA Conference Centre, Boundary Road, Newlands, Classroom 1, 3rd Floor
Time:	7.30am
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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