2024 INVESTMENT OUTLOOK

JANUARY 2024

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EXECUTIVE SUMMARY

Finishing the year on a strong note, South African markets followed global peers higher in the final quarter of 2023. For the full year, the FTSE/JSE All Share index was up 9.3%, which was marginally behind bonds (9.7%) but ahead of cash (7.8%). The standout performance for 2023 came from global equities, with the ACWI returning 31.3% (in rand).

Notable domestic developments over the past year include a moderation in the rate of price **inflation** (with the SARB holding the repo rate steady from the end of May – at 8.25%), GDP growth continuing to be hampered by **electricity and logistical constraints**, and the **domestic fiscal situation** coming (back) into focus.

We are of the view that **domestic interest rates** have likely reached their cycle peak and will probably be lower by the end of this year.

Both electricity and logistics are extremely important for the economy and their repair fall within the remit of Operation Vulindlela: Eskom is a bit further along its journey but there is also a keen focus within the Presidency on Transnet. There is much being done, but it **will take time and the journey will not be straight forward**.

The return of the **twin deficits** – so called for concurrent negative balances on the country's fiscal and current accounts – is placing pressure on government's finances (deficits need funding), which, in turn adds risk premia to the rand and sovereign bonds.

SA long bond yields followed those in in the US lower over the final quarter, translating into strong positive returns. The key driver of this was markets starting to expect looser monetary policy from key central banks – notably the Fed. Post this rally, the yield on bonds in SA have moved closer to fair value. They do, however, **remain high on a real basis**.

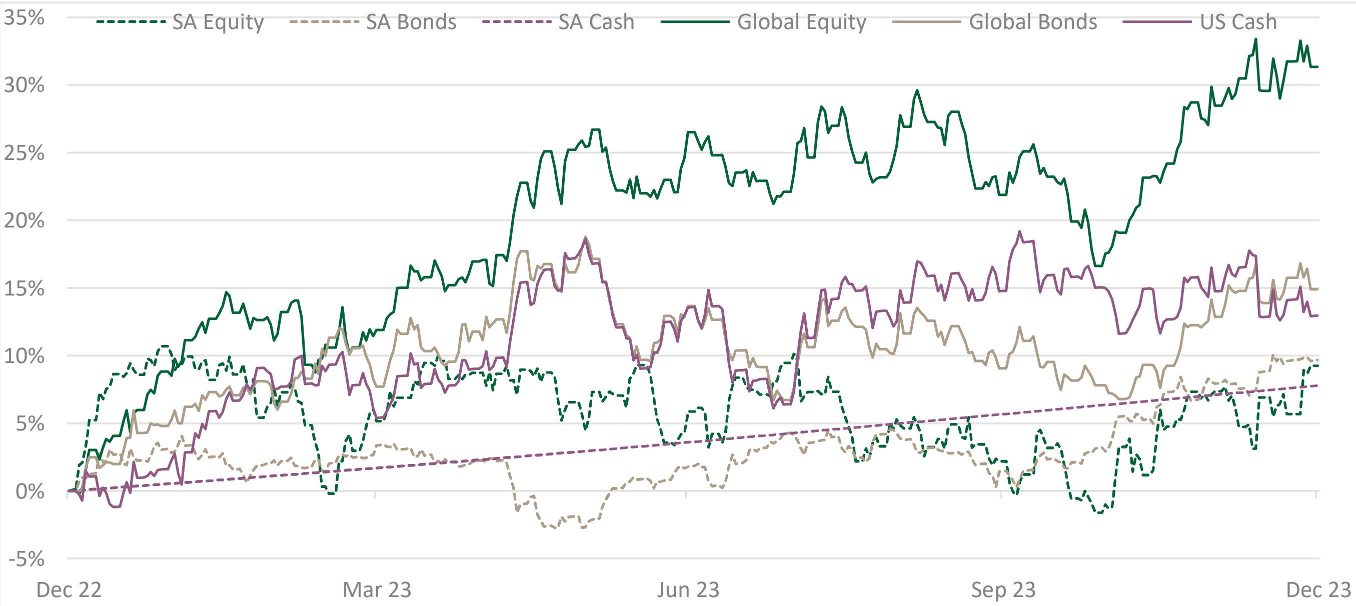
Looking ahead, we believe the **prognosis for SA equities** in aggregate rests on elevated dividend yields and undemanding valuations (especially vs EM and world equites). We also believe that foreign (and potentially some domestic) investors are sitting on the side-lines waiting to gauge the outcome of the national elections.

The South African economy and financial markets face many macro and political risks (on the domestic front, as well as from abroad) in 2024. In the US, our offshore colleagues believe entrenched disinflation will lift real income growth and **reduce the likelihood of a deep US recession**, which they estimate at c. 30% for the next 12 months.

INTRODUCTION

Finishing the year on a strong note, South African markets followed global peers higher in the final quarter of 2023. For the full year, the FTSE/JSE All Share index was up 9.3%, which was marginally behind bonds (9.7%) but ahead of cash (7.8%). On the back of guidance from the Fed and market expectations for interest rate cuts in 2024, the US dollar weakened, and the rand rallied 3.0% in the final quarter – but ending 7.8% **weaker** versus the US dollar compared to the end of 2022. The standout performance for 2023 came from global equities, with the ACWI returning 31.3% (in rand). Global bonds also showed a healthy recovery last year, returning 14.9% (in rand).

Chart 1: Global equity the winner in 2023[1]



Notable domestic developments over the past year include a moderation in the rate of price inflation (with the SARB holding the repo rate steady from the end of May – at 8.25%), GDP growth continuing to be hampered by electricity and logistical constraints, and the domestic fiscal situation coming (back) into focus. Tight global monetary policy and an underwhelming post-covid lockdown recovery in China also had a meaningful bearing on the domestic economy and financial markets.

ECONOMICS

Inflation and Interest Rates

Headline inflation continued to roll over as the year progressed, registering at 5.5% in November from a 2023 high of 7.1% in March. Core inflation, which excludes volatile items such as food and non-alcoholic beverages, fuel, and energy, remained relatively contained during the past three years – averaging 4.0% and never breaching the SARB's upper band of 6%.[2] Furthermore, factory gate prices, measured by changes in the Producer Price index ("PPI"), have also come right down; averaging 4.5% in the second half of last year versus 12.7% over the prior 18 months. Indicating that input cost pressures have abated and are not an outsized burden on consumer prices anymore.

What we read from this is that interest rates in South Africa have likely reached their cycle peak and will probably be lower by the end of this year. While the Fed only guided (at its December FOMC meeting) for lower interest rates in the US in 2024, market pricing for expected interest rates across most of the developed world, as well as those in South Africa, had already recalibrated lower. In fact, as of the end of the year, there was almost 1.0% worth

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[1] *Source: Morningstar Direct, as of 31 December 2023.*
[2] *Source: Stats SA, As of December 2023 (December CPI due 25 January 2024).*

of cuts to the repo rate priced in for 2024[3]. We believe the SARB will maintain the repo rate at its current restrictive level of 8.25% until after the SA national elections have been held, the Fed has started cutting US interest rates and some of the fiscal pressures have eased domestically.

Chart 2: SA Headline inflation lower in 2023[4]

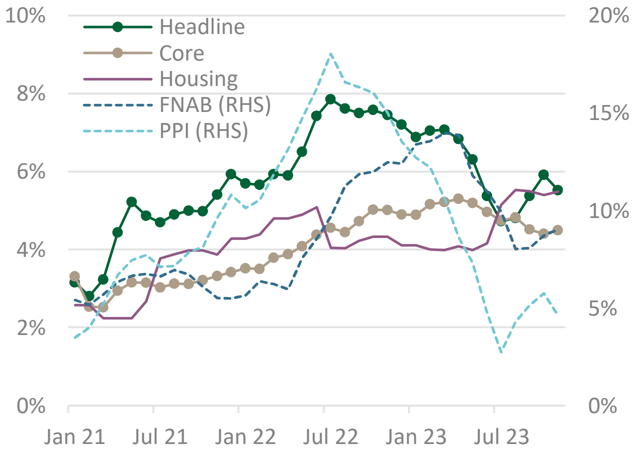
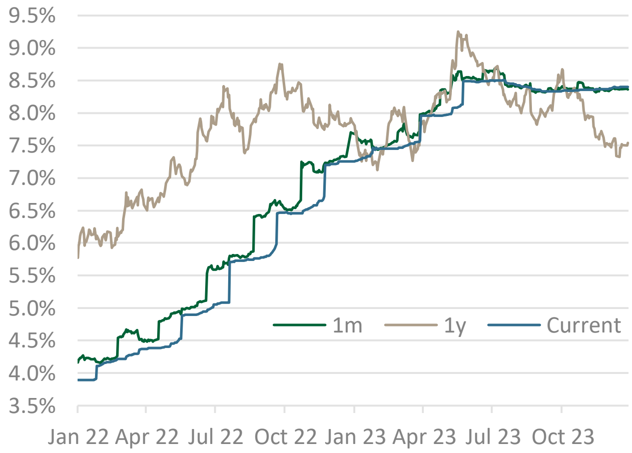


Chart 3: Market pricing in interest rate cuts in 2024[5]



Impediments to Growth

Electricity loadshedding abated somewhat in December and would have aided consumer facing businesses during the festive season. It was, however, a significant hindrance to the economy in 2023. We show electricity produced by Eskom in chart 4 below.

Eskom's first system outlook report of 2024 shows that the state-owned utility currently expects a weekly shortfall (supply versus demand) of more than 2 GW – translating to two stages of loadshedding on a daily basis. While this can vary depending on breakdowns and actual electricity demanded, **we don't believe SA will be completely out of the woods in 2024 from a loadshedding perspective.** On the positive side, investment in own-generation and renewables are already (and we expect to continue) bolstering electricity supply and affording some resiliency to the economy.

Logistical constraints at shipping ports and railways operated by Transnet have held back exports and caused import delays. An interesting chart to consider here is the trend in money spent on rail freight vs road freight in chart 5 below.

Both electricity and logistics are extremely important for the economy and their repair fall within the remit of *Operation Vulindlela*: Eskom is a bit further along its journey but there is also a keen focus within the Presidency on Transnet. There is much being done, but it will take time and the journey will not be straight forward. The next important milestone (for Transnet) will be the finalisation of The Economic Regulation and Transport Bill, which is currently scheduled for April of this year. This Bill would open the door for greater levels of private sector participation in the logistics network (over time).

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[3] *Source: Bloomberg, as of 31 December 2023.*
[4] *Source: Stats SA, As of December 2023 (December CPI due 25 January 2024).*
[5] *Source: Bloomberg, as of 31 December 2023.*

Chart 4: Eskom's share of electricity supply[6]

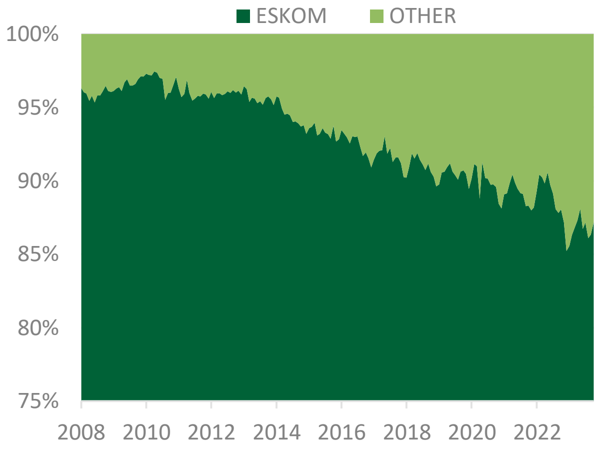
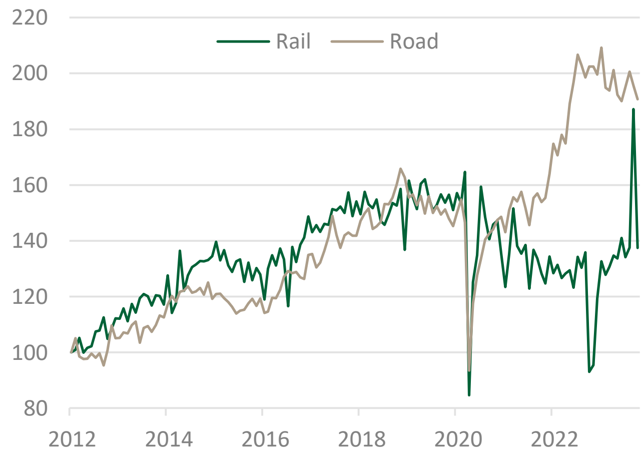


Chart 5: Value of freight moved via road vs rail[7]



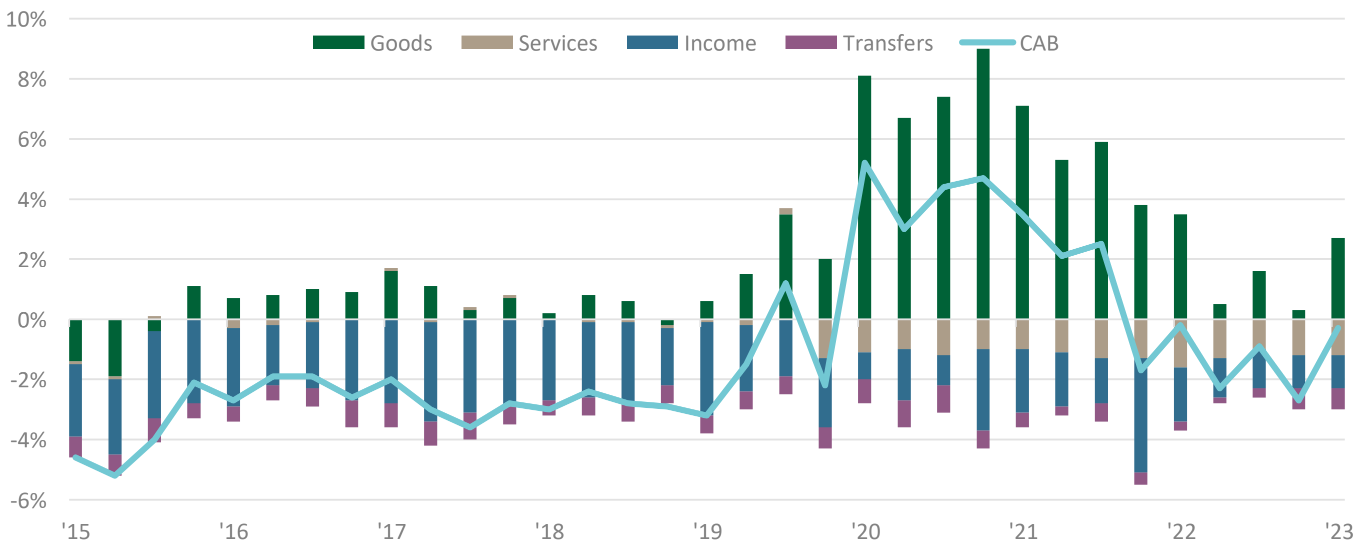
Fiscal Considerations

The return of the twin deficits – so called for concurrent negative balances on the country's fiscal and current accounts – is placing pressure on government's finances (deficits need funding), which, in turn adds risk premia to the rand and sovereign bonds. Lower prices of key commodity exports coupled with the logistical constraints noted above has caused the balance on the Current Account to revert to negative (chart 6).

The government's budget balance is predominantly impacted by a normalisation (reduction) in mining tax revenues collected, as well as increased outlays on public sector wages, SOE's, and social grants. While National Treasury has been standing its ground on the fiscal consolidation front, markets are currently pricing in risk (chart 7) that electioneering rhetoric impedes these efforts.

The annual budget speech, to be held at the end of February, will be closely observed for a continuation of prudence, but also for any further allocations to SOE's such as Transnet.

Chart 6: Current Account Balance reverting to longer term average [8]



[6] *Source: Stats SA, As of October 2023.*
[7] *Source: Stats SA, As of October 2023.*
[8] *Source: SARB, As of Q3 2023.*

FINANCIAL MARKETS

Fixed Income

SA long bond yields followed those in in the US lower over the **final quarter**, translating into strong positive returns. The key driver of this was markets starting to expect looser monetary policy from key central banks – notably the Fed. The South African All Bond index rose 8.1% (in rand), while its global compatriot, the Bloomberg Global Aggregate index, rallied 8.5% (in US dollar).

Chart 7: US and SA 10y government bond yields[9]

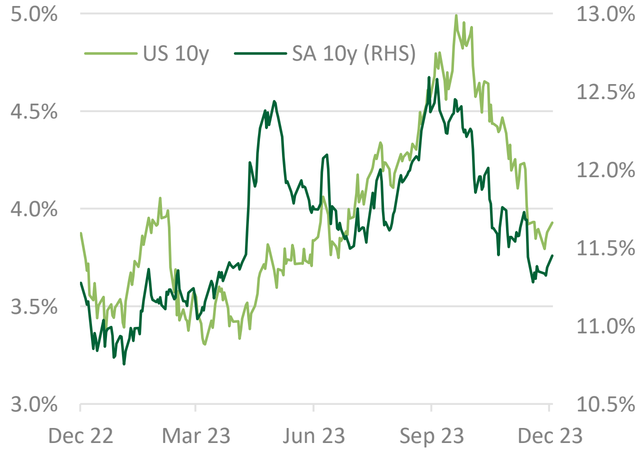
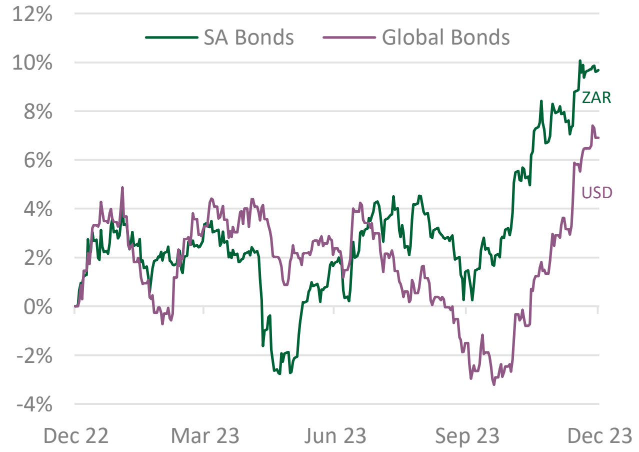


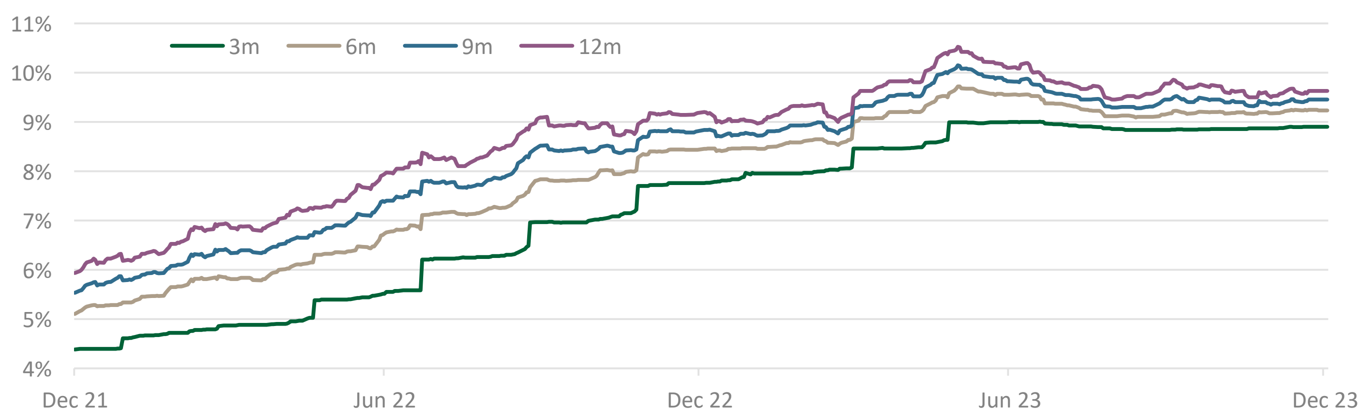
Chart 8: Global and SA bond returns[10]



Post this rally, the yield on bonds in SA have moved closer to fair value. They do, however, remain high on a real basis – with the SARB expecting inflation of 5% in 2024 (as of its November MPC meeting), the real yield on the R2035 at the end of last year was 6.4%. While there is a busy calendar ahead, with the National Budget and elections posing risks, we believe that as monetary policy loosens in the US, yields on SA government bonds will also move lower as 2024 progresses.

Yields offered on money market instruments remain attractive versus recent history and inflation expectations, but even these started to decline marginally from June highs. Should the SARB commence cutting the repo rate, these would move even lower, increasing the re-investment risk for investors "hiding out" in the high yields currently offered by cash and money market instruments.

Chart 9: SA money market rates[11]



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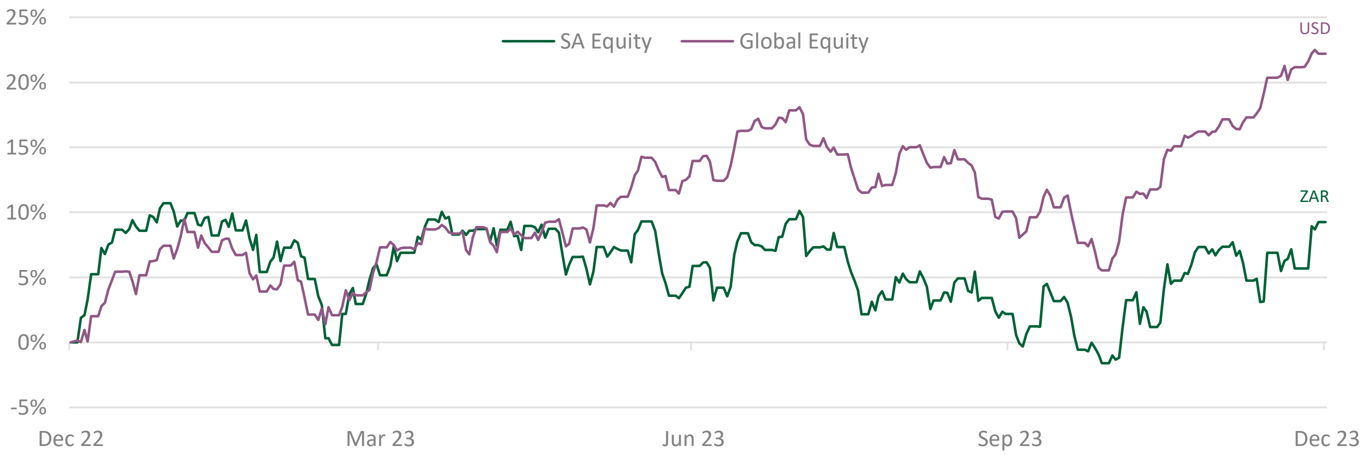
[9] *Source: Bloomberg, as of 31 December 2023.*
[10] *Source: Morningstar Direct, as of 31 December 2023. Note: SA bonds in ZAR and Global bonds in USD.*
[11] *Source: Bloomberg, as of 31 December 2023.*

Equity

It was a year where one was rewarded for holding global equities in a portfolio, but not in earnest until the final quarter (at the end of October, global equites had returned 6%; before rallying to end the year up 22% in US dollar). Participation also broadened beyond the dominance of the 'Magnificent 7[12]' technology giants. For globally diversified investors, this represents a welcome development following market declines in 2022 and a highly concentrated recovery for most of 2023.

Chart 10: Global and SA equity returns[13]



SA equities, while finishing the year strong, delivered returns in line with other domestic asset classes (and were flat through October). From a broad industry perspective, the largest 2023 outperformance came from SA Financials with a total return of +20.0%, followed by SA Industrials (+16.6%). SA Resources, however, recorded a loss of 11.8%.

Top equity sector performance for 2023 came from Pharmaceuticals: +50.6% (Aspen), Life Insurance: +38.9% (Sanlam +57, Momentum +34%, Old Mutual +33%, Discovery +17%) and Industrial Transport: +38.5% (Textainer +78%). Of the major equity sectors, the worst performance came from Chemicals: -21.0% (Sasol), Industrial Metals: -15.7% (Anglo -25%, ARM -22%) and Tobacco: -12.1% (BATS)[14].

Chart 11: Equity market valuations[15]

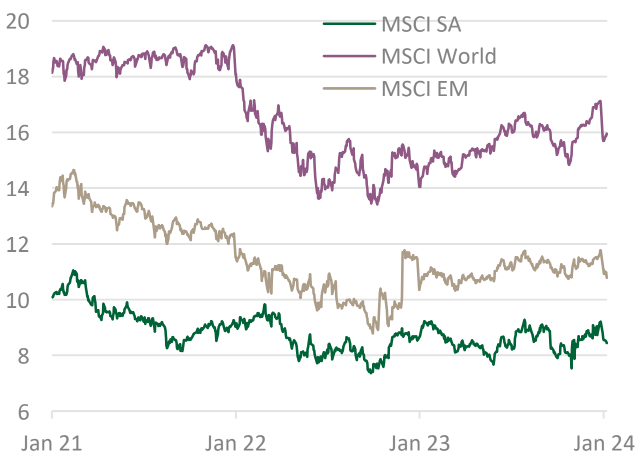
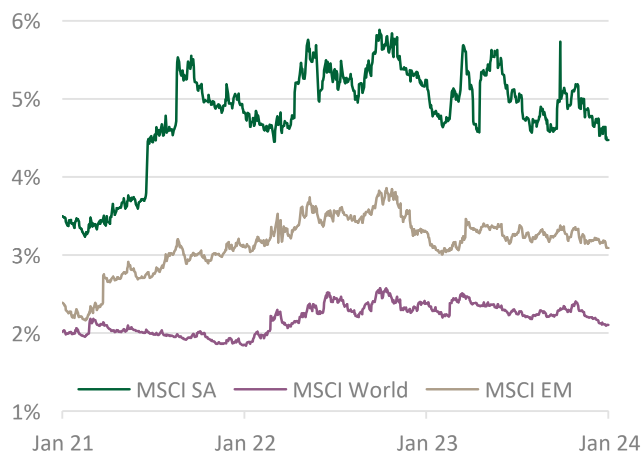


Chart 12: Dividend yields[16]



[12] *The Magnificent 7 are Apple, Amazon, Alphabet, Meta, Microsoft, Tesla and Nvidia.*
[13] *Source: Morningstar Direct, as of 31 December 2023. Note: SA equity in ZAR and Global equity in USD.*
[14] *Source: SBG Securities. As of 31 December 2023.*
[15] *Source: Bloomberg, as of 31 December 2023. Chart shows 12-month forward P/E ratios in base currency.*
[16] *Source: Bloomberg, as of 31 December 2023. Chart shows 12-month forward dividend yields in base currency.*

Looking ahead, we believe the prognosis for SA equities in aggregate rests on elevated dividend yields and undemanding valuations (especially vs EM and world equites). We also believe that foreign (and potentially some domestic) investors are sitting on the side-lines waiting to gauge the outcome of the national elections. Once this passes and the Fed commences cutting interest rates, there could be a rerating which would be beneficial to the equity market. Any strength in the global economy, and in particular China with the consequent impact on commodity prices, would also be positive for SA assets.

Summary

The South African economy and financial markets face many macro and political risks (on the domestic front, as well as from abroad) in 2024. Inflation has been and continues cooling off, with central banks set to assume a more accommodative stance than last year. In the US, our offshore colleagues believe entrenched disinflation will lift real income growth and contain the likelihood of a deep US recession, which they estimate at c. 30% for the next 12 months. Domestically, the SARB is likely to be a price taker – not cutting as aggressively as the Fed while fiscal and political risks apply pressure to the currency.

We wish you a happy and prosperous 2024.

SFIM SA Chief Investment Officer Group
January 2024

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