Q3 2024 INVESTMENT LETTER

OCTOBER 2024

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

EXECUTIVE SUMMARY

Domestic assets delivered strong returns in the third quarter, reflecting what could be the start of a tide change in investor sentiment towards South African markets. After returning 8.2% and 7.5% in the second quarter, the ALSI and ALBI indices rose a further 9.6% and 10.5%, respectively during the third quarter.

The South African rand ended the quarter 5.4% stronger against the US dollar. Over this period, the broad dollar index weakened by 2.5%, and 0.8% versus a basket of EM currencies. This implies a robust move for the local currency and reflective of optimism.

Having delivered the strongest 1-year return in over a decade, the South African bond market was one of the primary beneficiaries of investor optimism about the changing prospects of the economy. It has outpaced its emerging market peers and developed market counterparts by some margin.

A key question we constantly ask is what is in the price, and we now view SA government bonds to be close to fair value. That is, prior risk premia have been largely priced out by the market and, from here, it will depend on economic growth and further fiscal consolidation materialising.

We are on balance bullish in our outlook for SA equities in general, based on a more constructive backdrop and still undemanding valuations.

While longer-term (12-month) money market instruments are not paying what they used to (now around 8.2%), their yields are still high in real terms: the SARB forecasts inflation to average below 4.5% in 2025 and 2026. At that, these instruments continue to be a welcome asset to hold in our portfolios.

An improved political backdrop and potential for lower interest rates is reflected in both business and consumer sentiment starting to turn higher. We observe that consumer confidence is back to 2019 levels and that expected business conditions in six months' time has been and continues to move in a positive direction. It is a source of optimism for improved economic growth.

In this note, we pen down our thoughts on key domestic economic, political, and financial market developments – both what transpired over the quarter and what lies ahead. We touch on how our multi-asset portfolios are positioned to participate in any further upside and to guard against potential risks.

South Africa is an open economy, with its financial markets driven by what transpires globally. At that, for our views on the global economy and financial markets, we invite you to consider our Global CIO letter. Amongst others, the likelihood of a recessionary scenario in the US transpiring over the next year is considered, together with our thoughts on the recent developments in China (which has driven a lot of SA equity returns in the final week of the quarter).

INTRODUCTION

Domestic assets delivered strong returns in the third quarter, reflecting what could be the start of a tide change in investor sentiment towards South African markets. After returning 8.2% and 7.5% in the second quarter, the All Share (SA equities) and All Bond (SA bonds) indices rose a further 9.6% and 10.5%, respectively during the third quarter. Remarkably, the All Share is now ahead of global equities over the past three years, while the All Bond is ahead of the AC World (global equities) index over the past year. Table 1 and Chart 1 below reflect this[1].

A large part of global financial market moves is driven by what happens in the US. With the Federal Reserve having commenced cutting interest rates in September (by 0.5%), longer duration assets such as 10-year government bonds rallied – both in anticipation and because of this move. Global Aggregate (global bonds), for example, rallied 6.9% over the quarter when measured in US dollars. The rand has rallied since the GNU formation: 3.6% stronger over the second quarter, and a further 5.4% versus the US dollar over the third[2]. Factoring this into the returns of global assets compresses returns when measured in rand (but, at the same time, amplifies rand priced asset returns for investors measuring themselves in US dollars).

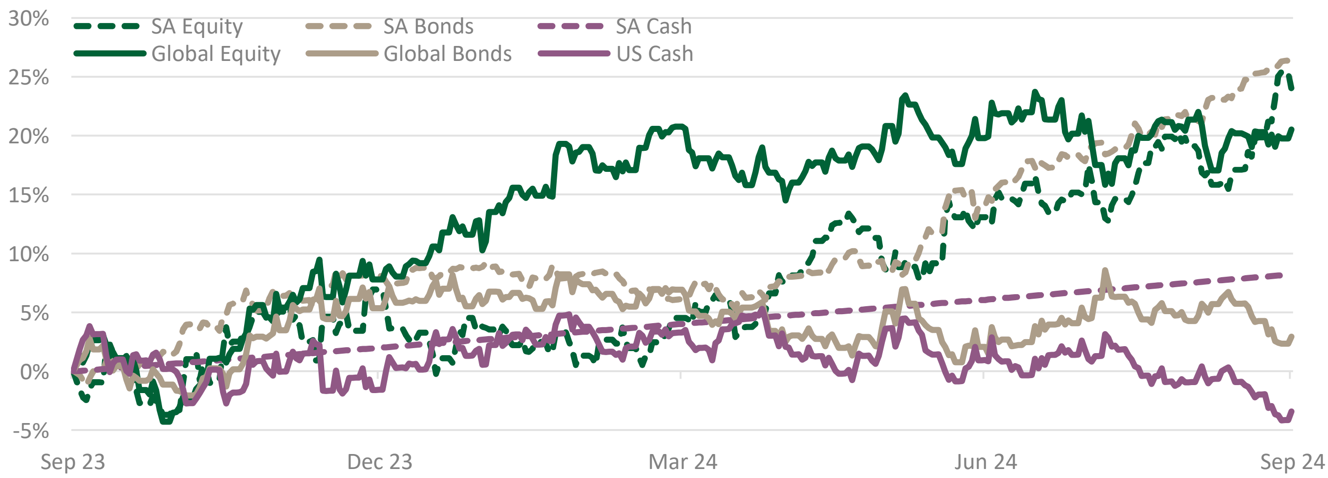
Table 1a: SA now ahead of global equity over 3 years

	3m	6m	1y	3y	5y
All Share	9.6%	18.6%	23.9%	14.7%	13.7%
AC World	0.6%	-0.2%	20.5%	13.1%	15.1%
All Bond	10.5%	18.8%	26.1%	11.1%	9.8%
Global Agg	0.9%	-3.7%	3.0%	1.4%	1.7%
SA Cash	2.1%	4.0%	8.2%	6.6%	5.7%
US Cash	-4.3%	-6.5%	-3.4%	8.4%	5.0%

Table 1b: Strong returns in SA equities & bonds this year

	YTD '24	2023	2022	2021	2020
All Share	15.9%	9.3%	3.6%	29.2%	7.0%
AC World	11.8%	31.3%	-13.0%	28.8%	22.1%
All Bond	16.7%	9.7%	4.3%	8.4%	8.7%
Global Agg	-2.3%	14.9%	-11.7%	2.8%	15.1%
SA Cash	6.1%	7.8%	4.9%	3.5%	4.5%
US Cash	-1.9%	13.0%	8.2%	8.7%	5.5%

Chart 1: GNU optimism reflected in SA Bond market rally; stronger ZAR affecting offshore asset returns



In this note, we pen down our thoughts on key domestic economic, political, and financial market developments – both what transpired over the quarter and what lies ahead. We touch on how our multi-asset portfolios are positioned to participate in any further upside and to guard against potential risks. South Africa is an open economy, with its financial markets driven by what transpires globally. At that, for our views on the global economy and financial markets, we invite you to consider our Global CIO letter. Amongst others, the likelihood of a recessionary scenario in the US transpiring over the next year is considered, together with our thoughts on the recent developments in China (which has driven a lot of SA equity returns in the final week of the quarter).

[1] *Source: Morningstar Direct. As of 30 September 2024. Total Return in ZAR. Periods longer than 12 months are shown annualised.*
[2] *Source: Bloomberg. As of 30 June 2024.*

Section 1 Economics

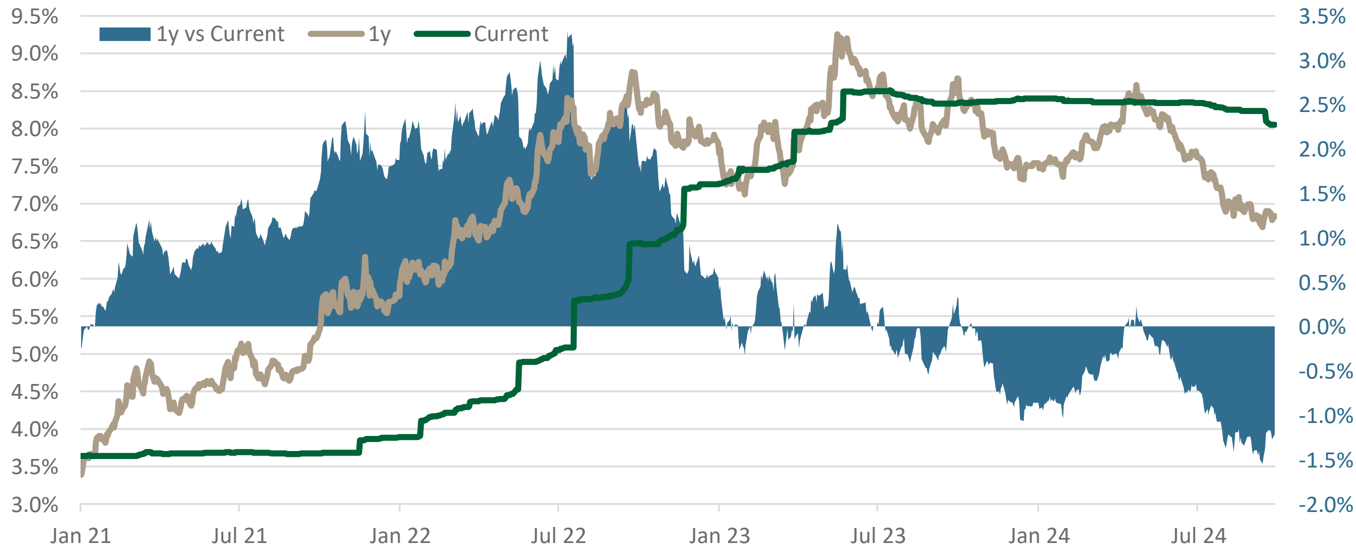
1.1 Inflation and Interest Rates

As inflation has continued to cool off across the globe, so too has it in SA. Annual headline inflation registered 4.4% at the end of August, with core inflation measuring 4.1%. After reaching a previous low of 4.8% a year ago, headline inflation subsequently reaccelerated before turning lower again during the third quarter of this year. Convinced that enough has been done to turn inflation decidedly lower this time, the SARB commenced cutting the repo rate and voted to do so by an initial 0.25% at its September MPC meeting. This was in line with economist expectations as well as those priced by the money market.

> While the direction of travel from here is widely expected to be lower, the path taken, and the eventual destination is uncertain.

We are in the camp that believes this interest rate cutting cycle will more likely be a shallow one, with another 0.75% to 1.25% worth of cuts materialising over the next six to twelve months. Considering chart 2 below, we note that money market pricing, which is relatively volatile, currently agrees with this outlook.

Chart 2: Money market pricing for further interest rate cuts[3]



Key risks to this outlook involve a reacceleration of inflation driven by sustained higher oil prices or a weaker exchange rate. Less unknown, but possibly more impactful, are electricity tariff increases – or administered price inflation. While the topic has garnered much attention of late, we consider the numbers. Annual inflation of administered prices averaged 8.3% per annum over the past two years, while headline inflation excluding administered prices was 4.8%[4]. Should tariffs continue to put pressure on headline inflation, the pace of interest rate cuts may slow, and the eventual level of interest rates may well be higher.

At a high level, we note from chart 3 below that surveyed expectations for average inflation over the next calendar year have also continued to moderate. At its latest reading, average expectations dipped decidedly below the 5% mark for the first time since 2021. This gives the SARB the comfort to have commenced cutting interest rates and, if continued, should not stand in the way of further cuts.

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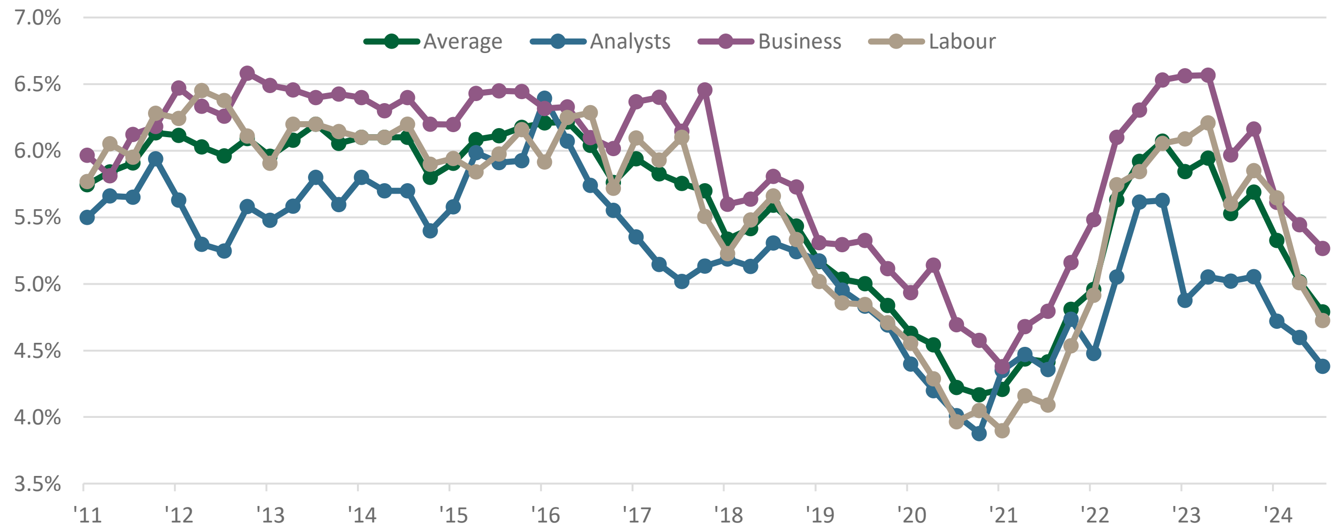
[3] Source: Bloomberg. As of 30 September 2024. Chart shows current 3-month interest rate and 3-month interest rates 1-year ahead as priced by the FRA market.

[4] Source: Stats SA, as of 31 August 2024.

Chart 3: Surveyed inflation expectations continue moving in the right direction[5]



1.2 Economic Growth

The South African economy expanded marginally (0.4%) in the second quarter of 2024 but was only 0.3% larger than a year earlier. On the production side, growth was broad based albeit muted. The finance industry contributed most, while transportation detracted. Considering growth through the expenditure lens, it was the expansion in household consumption contributing most, while imports detracted.

It is worth pausing to consider the outlook for growth in SA, with many economists having adjusted their forecasts for this year and next year's GDP growth higher. This mainly being due to electricity constraints having abated and the worst woes at Eskom seemingly in the rearview mirror. Potential for lower interest rates and an improved political backdrop is reflected in both business and consumer sentiment starting to turn higher. We observe this reflected in the indices in chart 4a[6] below, showing that consumer confidence is back to 2019 levels.

Chart 4a: Confidence turning a corner(?)

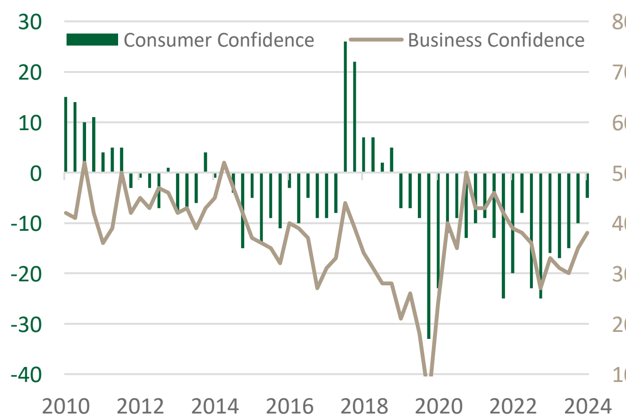
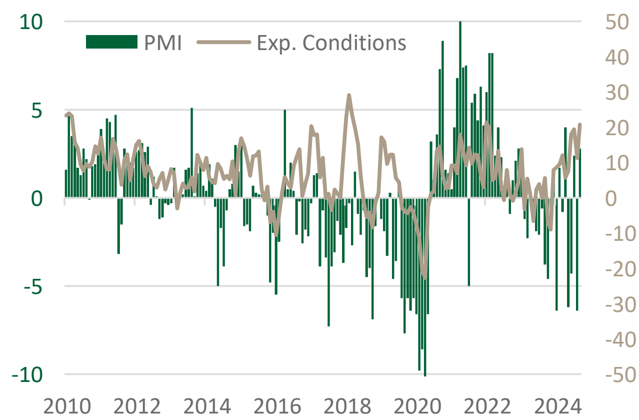


Chart 4b: Business conditions improving(?)



Then, in chart 4b[7] above, the expected business conditions in six months' time – a sub-index of the broader Purchasing Manager Index ("PMI") reflecting respondent views on future business conditions – has been and continues to move in a positive direction. It is a source of optimism for improved economic growth.

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[5] *Source: BER, as of Q3 2024.*
[6] *Source: BER, as of Q3 2024.*
[7] *Source: BER, as of 30 September 2024. Chart shows figures net of the neutral (50) level – to isolate expansionary / contractionary readings.*

Lastly, Operation Vulindlela ("OV") is entering it second phase. A cornerstone of OV is to cut red tape and to crowd in investment and expertise from the private sector. The work during the first phase bears a large part of the responsibility for loadshedding having ended and spectrum having been released to mobile network operators. Its work will be instrumental in building out a distribution network for state and independently produced electricity, as well as addressing the water infrastructure ailments in SA. It has already been, in what will eventually be a mammoth task, a key role player in the resuscitation of Transnet.

The Medium-Term Budget policy statement at the end of this month will contain valuable information on where National Treasury sees state resources being allocated – especially with significant funding requirements reflective of the dire situation at Transnet having come to light.

Section 2. Politics

We followed political developments after the national elections with keen interest. A coalition government was always going to be challenging, and we have witnessed some of these challenges play out in the media (some lamentably avoidable).

The main stress point at present lies in aligning working arrangements at a national level with those at a local level. This will take time, compromise, and creativity – with one or all of these always seeming to be in short supply. We do view the establishment of a formal dispute resolution mechanism within the GNU as a key positive, as it becomes the first port of call in addressing disagreements between members – as opposed to airing out frustrations in the media.

For now, while political noise levels have dropped compared to earlier in the year, risks remain. A main one being the passing of a motion of no confidence vote in President Ramaphosa raised in parliament by the EFF. We view the risk of this materialising as small, but the impact thereof, should it transpire, to be significant.

Section 3. Financial Markets

3.1 Currency

The South African rand ended the quarter 5.4% stronger against the US dollar[8]. Over this period, the broad dollar index weakened by 2.5%, and 0.8% versus a basket of EM currencies[9].

> This implies a robust move for the local currency and reflective of optimism.

Economists and financial markets have adjusted expectations to reflect a potential for the rand to keep strengthening from here. Being optimistic about the prospects for the local economy, a part of our thinking resides in that camp. But we know the rand is exceptionally volatile and sensitive to what happens outside its borders. Any extended geopolitical tensions impacting global risk sentiment will have a detrimental impact on the rand.

Furthermore, global market consensus on the Fed interest rate cutting path remains fluid – and the Fed can still surprise markets, as it did with a 0.5% cut in September. Should future economic data in the US remain stronger than currently anticipated, causing market expectations to shift towards fewer or smaller interest rate cuts, the US dollar would strengthen against the rand.

Cognisant of the SARB also having commenced an interest rate cutting cycle, the difference between both rates – and paths – will have a dynamic impact. For now, our expectation is for the SARB cutting cycle to be shallower than the Fed, which should support the rand.

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[8] *Source: Bloomberg. As of 30 September 2024.*
[9] *Source: FRED, Federal Reserve Bank of St. Louis. As of 30 September 2024.*

Chart 4: Amidst much volatility, the rand is over 8% stronger versus the US dollar this year[10]

3.2 Fixed Income

Having delivered the strongest 1-year return in over a decade, the South African bond market was one of the primary beneficiaries of investor optimism about the changing prospects of the economy. It has outpaced its emerging market peers and developed market counterparts by some margin.

A large part of this is also driven by monetary policy easing across the globe, due to realised inflation cooling and expectations for future inflation being lower – global bonds returned 6.9% (US dollar) in the third quarter[11]. But the lion's share of the rally can be attributed to compression of SA-specific country (economic and political) risk premia.

Table 2a: SA ahead of global and EM bonds

	3m	6m	1y	3y	5y
All Bond	10.5%	18.8%	26.1%	11.1%	7.1%
Global Agg	6.9%	-3.7%	3.0%	1.4%	-0.9%
EM Bonds	1.2%	-3.3%	1.8%	3.3%	-0.8%

Table 2b: Significant rally this year so far

	YTD '24	2023	2022	2021	2020
All Bond	16.7%	9.7%	4.3%	8.4%	8.7%
Global Agg	-2.3%	14.9%	-11.7%	2.8%	15.1%
EM Bonds	-1.7%	15.7%	-4.6%	-2.2%	7.8%

The figures in table 2[12] indicate just how strong performance has been. A key question we constantly ask is what is in the price, and we now view SA government bonds to be close to fair value. That is, prior risk premia have been largely priced out by the market and, from here, it will depend on economic growth and fiscal consolidation materialising.

We think it's useful to consider changes in yields as well as shifts in the curve to get a sense of bond market behaviour. In chart 5a below we note the large shifts in the curve as representing volatility but also shows the size of the risk premium that has been priced out by the market. The yield curve shifted around 200 basis points lower over the past six months, 120 over the prior three. Then, in chart 5b[13], we note how the US bond market has rallied too since the start of the second half of the year.

> Where our portfolios hold exposure to duration assets (longer maturity, fixed-rate bonds), these benefitted from this move over the quarter.

[10] Source: Bloomberg. As of 30 September 2024.
[11] Source: Morningstar. As of 30 September 2024.
[12] Source: Morningstar Direct. As of 30 September 2024. Total Return in ZAR. Periods longer than 12 months are shown annualised.
[13] Source: For both charts. Bloomberg. As of 30 September 2024.

Chart 5a: SA government bond yield curve

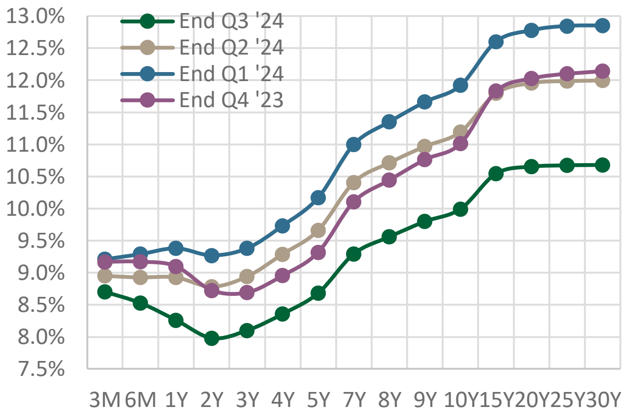
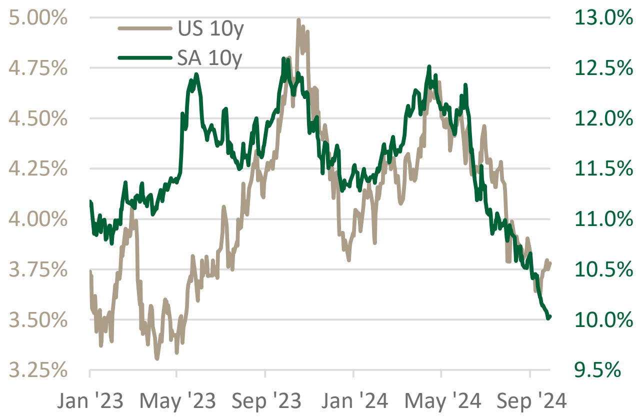


Chart 5b: US & SA 10-year government bond yields



Short-term money market rates have reduced to reflect the start of the interest rate cutting cycle. While longer-term (12-month) maturities are not paying what they used to (now around 8.2%) they are still high in real terms: the SARB[14] forecasts inflation to average below 4.5% in 2025 and 2026. At that, these instruments continue to be a welcome asset to hold in our portfolios.

3.3 Equity

The South African equity market also continued its run of delivering robust returns. The ALSI index was up 9.6% in the third quarter of 2024, outperforming the EM and DM peers in rand. The main drivers of this performance continued to be SA Inc. companies (so called for deriving most or all their revenues domestically) rallying on optimism for improved micro and macro-economic prospects.

Looking under the surface, small cap stocks outperformed in Q3 with a total return of 15.6%. Mid-caps returned 10.9%, while large caps returned 8.3%. Financials returned 14.3% in Q3, and Industrials returned 11.6%. Resources, however, lost 1.5%. Within Industrials, the strongest performance came from Construction & Materials (+38.2%), and within Financials it was the Non-life Insurance companies (+22.4%)[15]. A reminder that, where appropriate, we also engage global assets within our domestic portfolios and have participated in the strong year-to-date performance delivered by these markets too.

> We are on balance bullish in our outlook for SA equities in general, and offer some of our views below:

- We believe bonds have advanced ahead of equities on post-election optimism and think there is a catch-up to be had (especially so for smaller companies and within the Industrials sector in particular).
- Real GDP growth has been flat over the past decade, and now feels like the wheels of change are starting to turn – with the worst of loadshedding seemingly behind us and work commencing in earnest to ameliorate logistical ailments. Economists have broadly revised growth expectations higher: the SARB currently forecasts GDP to expand by 1.6% and 1.8% in 2025 and 2026.
- Lower interest rates bode well for consumers and businesses alike. This should be supportive of further re-rating in equities. The business and consumer confidence indicators are already starting to partially reflect this.
- While foreign investors have not returned to the SA equity market yet as they have in the bond market, we believe that once strong macroeconomic data prints start to materialise, these funds may start to flow. At the

[14] *Source: South African Reserve Bank – Monetary Policy Committee statement (19 September 2024).*
[15] *Source: For all returns data – Bloomberg. As of 30 September 2024.*

same time, post the amendments to Regulation 28 (stipulating fund managers may allocate up to 45% of their assets offshore), we see most of these shifts having largely been made[16]. This reduces the selling pressure faced by domestic equites over the past two years.

- Despite the rally this year, aggregate valuations remain undemanding – especially so versus emerging market peers and versus longer term averages.
- We currently see three main risks: 1) extended geopolitical tensions, especially in the Middle East affecting oil prices and global risk sentiment, 2) a global recession, and 3) disruptive coalition politics domestically.

Chart 6a: SA equity valuations remain compelling[17]

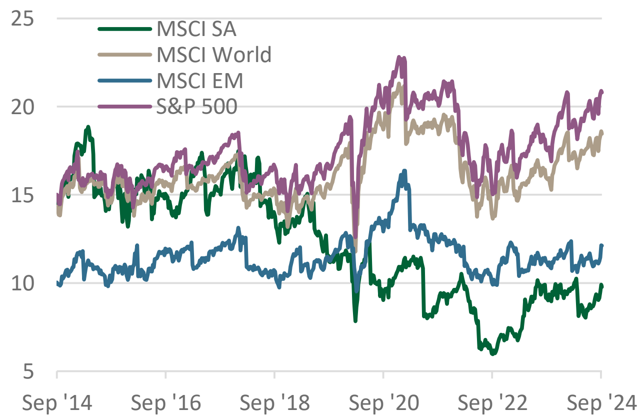
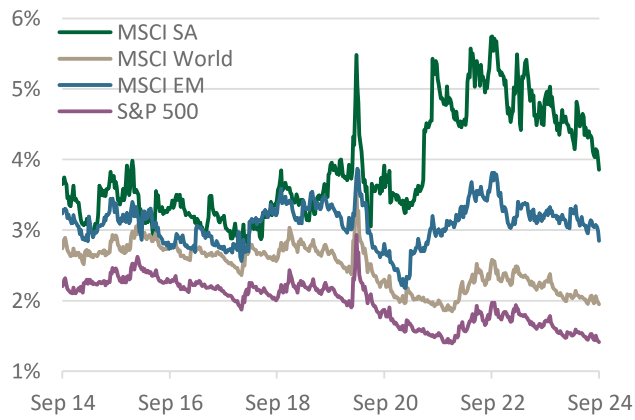


Chart 6b: With still attractive dividend yields



SUMMARY

Our outlook for the South African financial markets is optimistic, but subject to some risks and uncertainties. Our optimism rests on there being opportunity under the coalition government for continued structural reform and fiscal consolidation, with asset valuations still attractive. Together with inflation rolling over, allowing the SARB to cut interest rates this year (following other global central banks) providing financial relief to under pressure consumers.

We remain alert to the opportunities and risks unfolding. Believing the South African bond and equity markets to remain resilient, but volatile, we are following a balanced and diversified approach to allocating client capital.

We thank you for your continued support.

SFIM SA Investment Committee
October 2024

[16] Source: Alexander Forbes Large Manager Watch. As of June 2024.
[17] Source for both charts: Bloomberg, as of 30 September 2024.

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