Q4 2024 INVESTMENT LETTER

JANUARY 2025

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

EXECUTIVE SUMMARY

The final month of 2024 reminded us of the sensitivities of South African asset prices to developments outside our borders, with risk-off sentiment causing the broad US dollar index to rally 7.6% - effectively reversing the strong rally in the rand since our election.

Considering the year in its entirety, has us noting that it was a good one for domestic assets in general – with small cap companies and longer duration government bonds being standout performers.

While much good has come post the National Elections, a lot of work lies ahead – especially from a logistical perspective. We look for the rubber to hit the road in the first half of 2025 if the positive momentum is to be maintained and higher consumer and business optimism to follow through to increased consumption and capital expenditure.

From a financial market perspective:

- We now view SA government bonds to be priced 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, their yields are still high in real terms.
- At that, these instruments continue to be welcome assets to hold in our portfolios.

In our note we highlight some of what we view to be important economic, political, and financial market data – expressing our views and how we have positioned our portfolios. For our views on the global economy and financial markets, we invite you to consider our Global CIO letter. Amongst others, we take stock of the health of the US, European, and Chinese economies.

INTRODUCTION

After rallying for the most part of the second half of the year, domestic assets came under pressure in the final month. As is commonplace in financial markets, this was largely driven by the outcome of the December meeting of the US Federal Reserve Bank's Federal Open Market Committee's ("FOMC"). Continued strong economic data, and uncertainty around policies to be implemented by the incoming administration had members guide for the pace of any further interest cuts to be more gradually implemented – driving yields and the US dollar higher, and risk assets lower.

But let's not succumb to the habit of remembering something for how it concluded, and rather consider the economic and financial market good fortune that transpired throughout the year. Inflation continued to cool off, with most central banks about two-thirds of the way through interest rate cutting cycles. A recession did not transpire in the US. In fact, US equities had another stellar year, with the S&P 500 index up 25.0% in US dollar.

In South Africa, the outcome of the National Elections was markedly positive. Here too, inflation is contained, business and consumer confidence are at multi-year highs, and loadshedding is no longer the main topic discussed in social settings.

The JSE All Share index (SA equities) ended the year up 13.4% in rand terms, but it was the bond market (JSE All Bond) that truly shined, returning 17.2%. Together with this, and reflective of the optimism around the outlook for the economy and domestically oriented businesses, the index of small companies (JSE Small Cap) rallied 35.6%.[1].

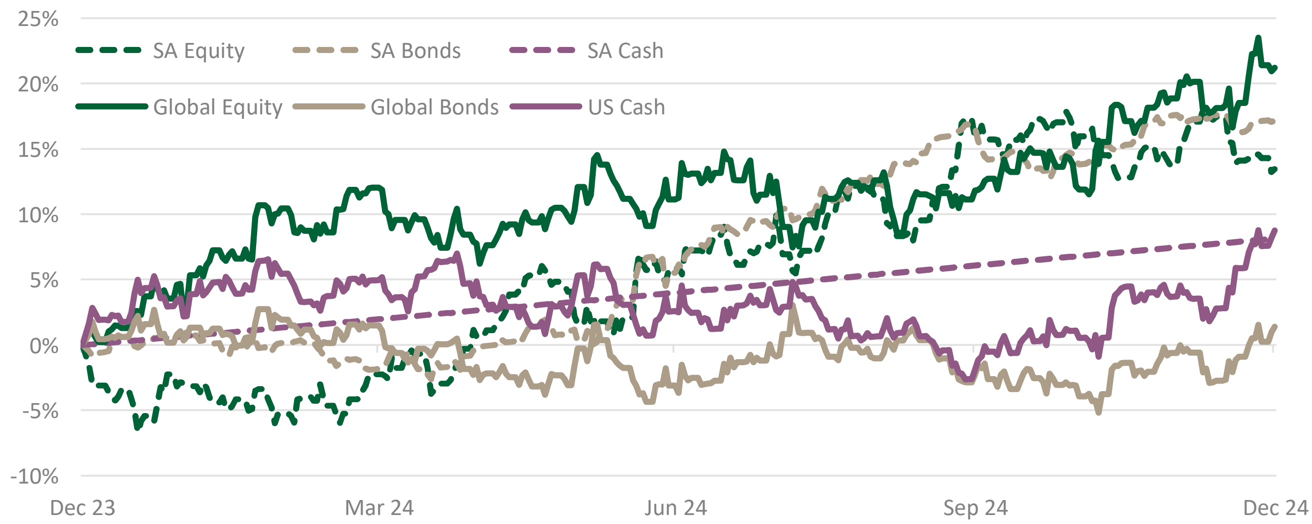
Table 1a: A good year for SA Equity

	3m	6m	1y	3y	5y
All Share	-2.1%	7.3%	13.4%	8.7%	12.2%
AC World	8.4%	9.1%	21.2%	11.5%	16.9%
All Bond	0.4%	11.0%	17.2%	10.3%	9.6%
Global Agg	3.7%	4.6%	1.4%	1.0%	4.0%
SA Cash	1.9%	4.0%	8.2%	6.9%	5.8%
US Cash	10.8%	6.0%	8.8%	10.0%	8.8%

Table 1b: But SA Bonds deliver stronger returns

	2024	2023	2022	2021	2020
All Share	13.4%	9.3%	3.6%	29.2%	7.0%
AC World	21.2%	31.3%	-13.0%	28.8%	22.1%
All Bond	17.2%	9.7%	4.3%	8.4%	8.7%
Global Agg	1.4%	14.9%	-11.7%	2.8%	15.1%
SA Cash	8.2%	7.8%	4.9%	3.5%	4.5%
US Cash	8.8%	13.0%	8.2%	8.7%	5.5%

Chart 1: While US dollar rallies in December, it was a good year for domestic assets in general



[1] *Source: For all data on this page. Morningstar Direct. As of 31 December 2024. Unless otherwise stated, return figures represent total return in ZAR. Periods longer than 12 months are shown annualised.*

On the other side of the coin, there is much work still to be done, and the road ahead is by definition uncertain and not without risk. While there has been much improvement on the electricity front – aided by the good work under the first phase of Operation Vulindlela ("OV") – grasping the significance of the task of turning around the fortunes of Transnet is only just beginning. The water infrastructure crises befalling much of the country combined with fixing local municipalities to enable basic service delivery, amongst others, will put OV to the test as it embarks on the second phase of its work.

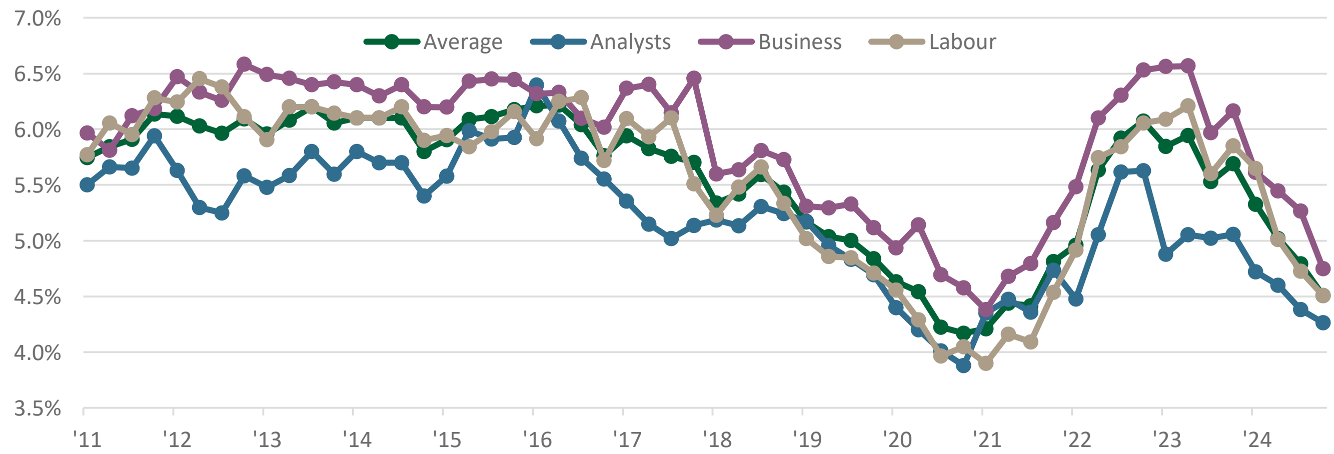
All of this will cost money, and National Government will need to involve the private sector – both requiring pragmatism and creativity. In short, we have an opportunity for good to be done – asset prices and sentiment surveys reflect this optimism. But the rubber will need to hit the road, in our view, in the first half of 2025 for the positive momentum to be maintained.

Section 1 Economics

1.1 Inflation and Interest Rates

At a high level, we note from chart 2 below that surveyed expectations for average inflation over the next calendar year have continued to moderate. At its latest reading, average expectations reached the critical 4.5% mark for the first time since 2021 – this being the midpoint of the SARB's current inflation target bands of 3-6%. This gives the SARB the comfort to cut interest rate and, if continued, should not stand in the way of further cuts.

Chart 2: Surveyed inflation expectations reach implicit SARB target[2]

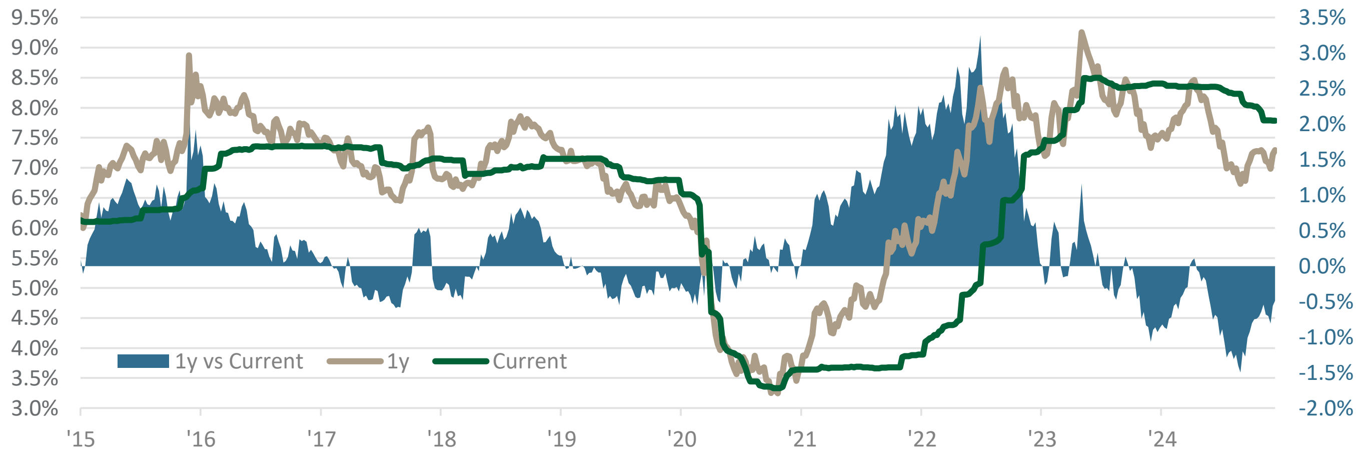


As inflation has continued to cool off across the globe, so too has it in SA. Annual headline inflation registered 2.9% at the end of November, with core inflation measuring 3.7%. Convinced that enough has been done to turn inflation decidedly lower this time, after the SARB commenced cutting the repo rate by an initial 0.25% at its September MPC meeting, it subsequently cut by a further 0.25% in November. This was in line with economist expectations as well as those priced by the money market.

We are in the camp that believes this interest rate cutting cycle will more likely be a shallow one, with another 0.50% worth of cuts materialising in the first half of 2025 (culminating in a terminal repo rate of 7.25%). Considering chart 3 below, we note that money market pricing, which is relatively volatile, currently agrees with this outlook.

[2] *Source: BER, as of Q4 2024.*

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



Key risks to this outlook involve a reacceleration of inflation driven by <u>sustained</u> higher oil prices or a weaker exchange rate. Less unknown, but possibly more impactful, are electricity tariff increases – or other administered price inflation.

1.2 Economic Growth

The South African economy contracted marginally (-0.3%) in the third quarter of 2024 and was only 0.3% larger than a year earlier, defying market expectations of a 1.2% growth[4]. A meaningful detractor in an otherwise unremarkable print was the agriculture sector, for which contracted by 28.8% (detracting 0.7%) during the quarter.

While Gross Fixed Capital Formation ("GFCF") – investment / capital expenditure – has started to turn, it is still isolated to government and SOE sectors. For the private sector, a general upswing in fixed investment may take time, with companies assessing the durability of the positive developments. At that, 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. Lower interest rates and an improved political backdrop is reflected in both business and consumer sentiment turning higher. We observe this reflected in the indices in chart 4a[5], showing that consumer confidence is back to 2019 levels.

Chart 4a: Confidence continues turning a corner

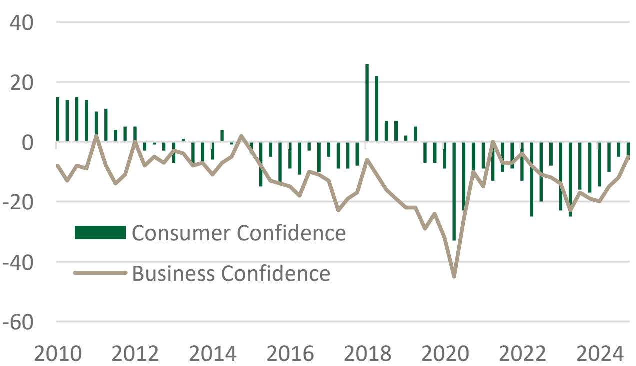
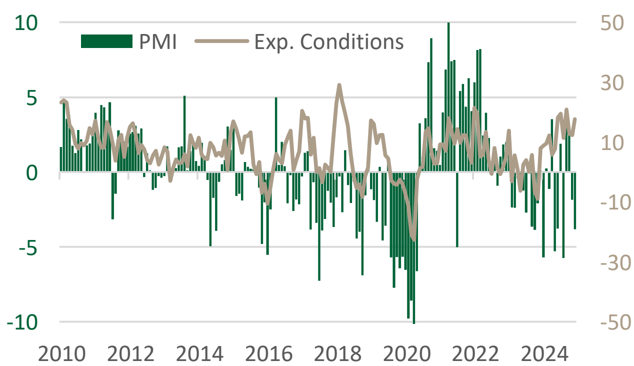


Chart 4b: Business conditions to improve(?)



[3] *Source: Bloomberg. As of 31 December 2024. Chart shows current 3-month interest rate and 3-month interest rates 1-year ahead as priced by the FRA market.*
[4] *Source: StatsSA, as of Q3 2024 (released 3 December 2024).*
[5] *Source: BER, as of Q4 2024. Business Confidence is shown net of the neutral (50) level – to isolate expansionary / contractionary readings.*

Then, in chart 4b[6] 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. In November last year, while not shown graphically here, the South African Chamber of Commerce and Industry ("SACCI") business confidence index reached its highest level since October 2015. These are sources of optimism for improved economic growth.

The Annual Budget policy statement at the end of next 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.

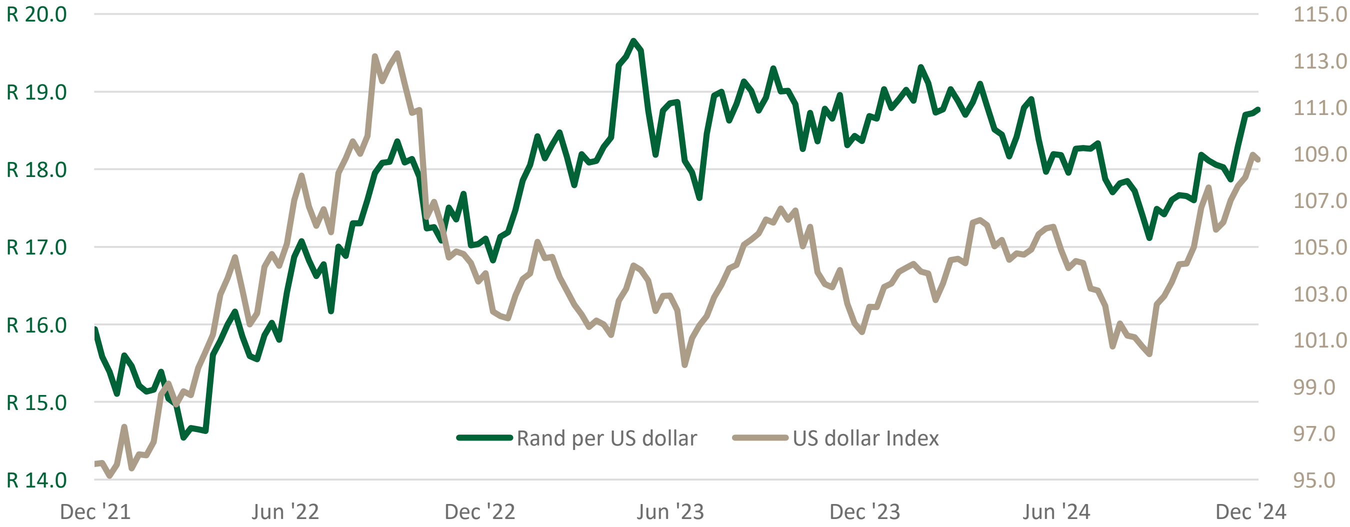
Section 2. Financial Markets

2.1 Currency

The South African rand ended the quarter 9.3% weaker against the US dollar[7]. Over this period, the broad dollar index strengthened by 7.6%. This indicates a strong reaction of the US dollar to perceptions of potential paths for monetary policy and fiscal policy uncertainty ahead of the incoming US administration, effectively putting the rand's rally on hold.

Regarding the rand, economists and financial markets had initially adjusted expectations to reflect a potential for the rand to remain strong in 2025. Being optimistic about the prospects for the local economy, a part of our thinking still resides in this camp. But we know the rand is exceptionally volatile and sensitive to what happens outside its borders. While the expectation has broadly been for the US dollar to weaken in 2025, we view this potential direction of travel to likely be pushed out until markets gain more clarity on the policy intention of incoming US administration. Cognisant of the SARB about halfway through its interest rate cutting cycle, the difference between it and that of the US – 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.

Chart 5: A stronger US dollar in the final quarter puts a dampener on the rally in the rand [8]



[6] *Source: BER, as of 31 December 2024. Chart shows figures net of the neutral (50) level – to isolate expansionary / contractionary readings.*
[7] *Source: Bloomberg. As of 30 September 2024.*
[8] *Source: Bloomberg. As of 31 December 2024.*

2.2 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 the 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 -5.3% (US dollar) in the fourth quarter[9]. But the lion's share of the rally can be attributed to compression of SA-specific country (economic and political) risk premia.

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 consider changes in yields as well as shifts in the curve to get a sense of bond market behaviour. In chart 6a we note the large downward shift in the curve, albeit in a volatile path, which shows the size of the risk premium that has been priced out by the market. The yield curve shifted around 70 basis points lower over the past six months, 40 over the year. Then, in chart 6b[10], we note how the US bond market sold off (yields rise) in the final quarter. While the SA bond market didn't weaken by nearly as much.

Chart 6a: SA government bond yield curve

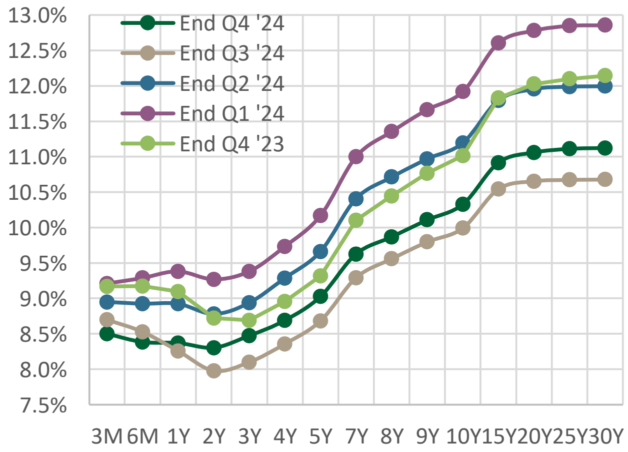
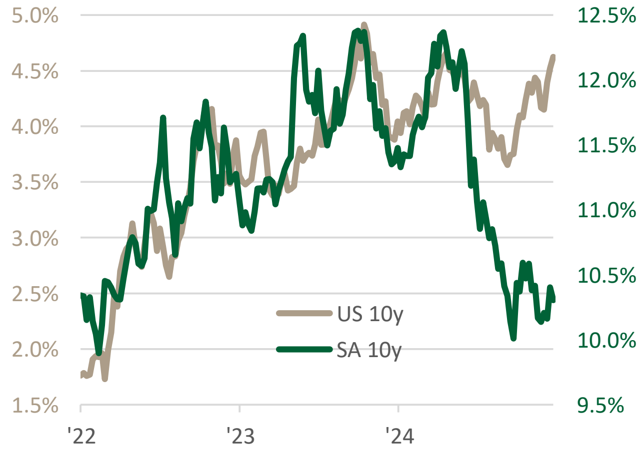


Chart 6b: US & SA 10-year government bond yields



Short-term money market rates have reduced to reflect the lower repo rate. While longer-term (12-month) maturities are not paying what they used to (now around 8.1%[11]) they are still high in real terms: the SARB[12] forecasts inflation to average below 4.0% in 2025 and 4.6% in 2026. At that, these instruments continue to be a welcome asset to hold in our portfolios.

[9] *Source: Morningstar. As of 31 December 2024.*
[10] *Source: For both charts. Bloomberg. As of 31 December 2024.*
[11] *Source: Bloomberg. As of 31 December 2024.*
[12] *Source: South African Reserve Bank – Monetary Policy Committee statement (21 November 2024).*

2.3 Equity

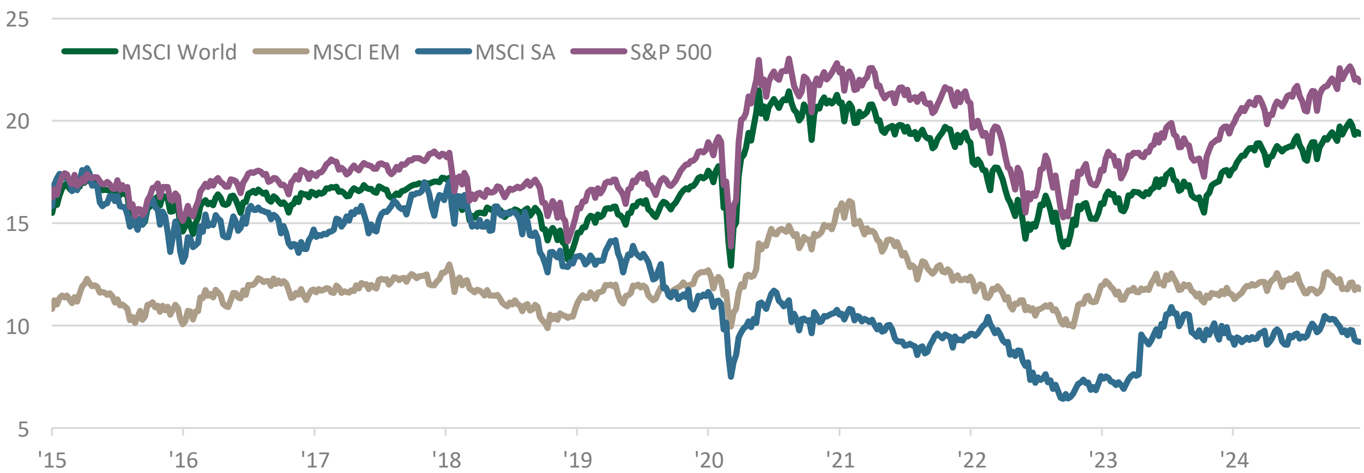
As mentioned before, the South African equity market delivered robust returns in 2024. The main drivers of this performance continued to be SA Inc. companies (so called for deriving most or all of their revenues domestically) rallying on optimism for improved micro and macro-economic prospects.

Looking under the surface, small cap stocks came out on top, returning 35.6%. Mid-caps returned 15.4%%, while large caps returned 10.7%. Financials returned 23.1% in 2024, and Industrials returned 18.5%. Resources, however, were down 8.7%. 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 1.7% 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 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[13]. 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 escalated geopolitical tensions, especially in the Middle East affecting oil prices and global risk sentiment, 2) volatility under a Trump presidency, and 3) disruptive coalition politics domestically.

Chart 7a: SA equity valuations remain compelling versus peers[14]



[13] *Source: Morningstar. As of 31 December 2024.*
[14] *Source for both charts: Bloomberg, as of 31 December 2024. Charts show 12-month forward Price-to-Earnings ratios.*

Chart 7b: And, versus their own history

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 continue cutting 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
January 2025

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