OLD MUTUAL MULTI-MANAGERS

# LOOK BOTH WAYS BEFORE CROSSING

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Another calendar year has come and gone, and we can reflect on the year that was and the year that lies ahead. This is in keeping with the spirit of January, named after the Roman god Janus, who had two faces, one looking back, and one looking forward.

## LOOKING BACK

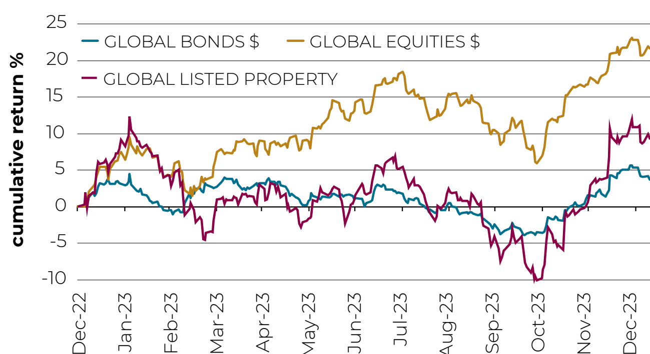
The world is gradually putting the shock of the Covid pandemic behind it, not so much the direct impact of lockdowns, which are thankfully a distant memory by now (though not quite so distant in China), but the aftershock of surging inflation and higher interest rates.

It is worth remembering that 2023 started on a very pessimistic footing, with a widespread expectation of a recession in the US and other major developed economies due to the impact of the rapid rise in rates. The only country where the outlook was for an improvement on the prior year was China, which was finally exiting lockdowns.

Instead, the US economy defied the gloomy predictions and actually accelerated during the year. Despite this, inflation steadily declined to the point where rate hikes were no longer needed. The net result: the global benchmark MSCI All Country World index returned 22.5% in dollars in 2023. Instead of a correction, we got a bull market.

If nothing else, this is a reminder of how wrong the consensus often is, and how difficult it is to predict the future. The best strategy in most cases is simply to be diversified but to stay invested, irrespective of the noise.

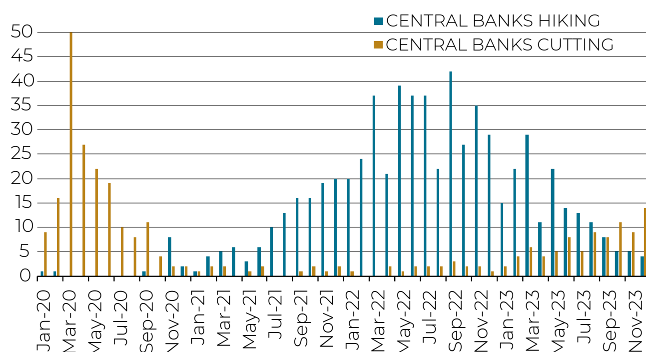
**Chart 1: Global asset classes in 2023 (US$)**




Source: Refinitiv Datastream

Nonetheless, let's look at what has been happening in the world economy and what the consequences might be. As chart 1 shows, 2021 to 2023 saw the most synchronised hiking cycle on record, but it is starting to turn. So far it is mostly emerging markets who were early hikers who have started reducing rates. It is the major developed market central banks, notably the US Federal Reserve, that matter for markets. It is their turn to cut now.

**Chart 2: The number of central banks changing interest rates**




Source: CBrates.com

In the US, inflation is still cooling (the Fed's preferred inflation measure, core PCE, printed 3.1% year-on-year in November but only 1.8% on a six-month annualised basis) the Fed is getting ready to cut rates. The 'dot plot' summary of projections of individual Fed officials suggest three 25 basis point cuts in 2024. The market is pricing in even more, closer to six cuts.

Meanwhile, most indicators of US economic activity remain solid, apart from manufacturing, which is in a global slump, and the interest-rate sensitive housing sector. Consumer spending is still rising at a decent pace as households benefit from wage growth of 4% to 5% (depending on the measure) and falling inflation. The unemployment rate was 3.7% in December, continuing the longest stretch under 4% since the early 1970s.

In Europe the situation is less rosy, and its economy might already be in recession. That European equity markets also rallied last year is a reminder that it is usually the US outlook that matters more for equity markets, even in other countries. The one bit of good news for the struggling eurozone economy is that a rapid decline in inflation creates room for the European Central Bank to also cut rates soon. Headline inflation was above 8% at the start of 2023 but ended the year at 2.9%. Core inflation fell from 5.6% to 3.4%. On a six-month annualised basis, it was 2% in December.

In China, optimism over economic reopening quickly gave way to a near-debilitating uncertainty and lack of confidence among households and businesses. The lockdowns exposed several deep-seated challenges, including a shrinking workforce, excess industrial capacity, falling property prices and too much debt. Headline consumer inflation fell deeper into negative territory

in November (CPI was 0.5% lower than a year ago) while core inflation was below 1% for the 11th straight month. Producer inflation is deeply negative. This persistently low inflation at a time when the rest of the world has been trying to combat elevated price pressures is indicative of economic weakness and suggests more policy easing lies ahead. Chinese markets had a terrible year, and were not cheered up by the improved US outlook at all. Chinese equities lost 10% in 2023, and basically halved the return of the MSCI Emerging Markets Index. Excluding China, emerging market equities returned 20% in dollars in 2023, a robust outcome. South Africa was one of the laggards among emerging markets, no surprises given its close links to China. The FTSE/JSE Capped Swix Index was flat in dollar terms in 2023, but returned 7.8% in rands, an outcome in line with cash (Stefi).

## LOOKING AHEAD

The biggest focus area for investors this year is therefore whether the soft-landing underway in the US remains on course. While interest rates are likely to fall across major economies they can fall for good or bad reasons. A good reason would be if inflation eased enough for central banks to take their feet off the brakes. A bad reason would be if economies were slipping into recession. If it is the former – and that appears to be the case in the US at least – rates might not fall as much as markets anticipate.

Politics and geopolitics will also feature in 2024. The last few weeks have seen an escalation in tensions in the Middle East with Houthi rebels in Yemen threatening one of the world's busiest shipping routes. The Houthis, along with Hezbollah in Lebanon, are closely linked to Iran. Iran itself suffered a horrific terrorist attack on the anniversary of the 2020 assassination of General Qasem Soleimani. However, the lacklustre response in the oil price, which remains below $80 a barrel, suggests markets are not too concerned at the prospect of a broader Middle Eastern war.

In terms of politics, a record number of people will be voting this year, as three of the four most populous countries on earth (India, Indonesia and the US) go to the polls. In the case of the US, a rerun of the 2020 Trump-Biden contest looks likely. A Biden win would mean more of the same, but a Trump win could throw many cats among many pigeons. However, in a tight election, it isn't a given that either party will win a clean sweep. If the White House and Congress are controlled by different parties, not much will change in terms of domestic economic policy. However, in the realm of international affairs, the president has more scope to act on his own. Diplomats across the world will watch the election with trepidation.

## LOOKING CLOSER TO HOME

South Africans will also vote this year, and for the first time since 1994, the ANC's grip on power is under threat. However, even if its support slips below 50%, it is likely to partner with a smaller party to remain in office. Therefore, the outlook is largely one of broad policy continuity, and ongoing gradual progress in tackling the pressing concerns of loadshedding, a crumbling logistics network, crime, corruption and excess government debt. Despite the looming election (probably in May), the February Budget Speech is likely to continue the emphasis on fiscal consolidation with little by way of pre-poll populist giveaways. This is unlike other emerging markets, where elections often distort fiscal policy as governments spend to remain power.

Although the local economy generally performed better than expected in 2023, it was still a bleak year (apart from the euphoria of retaining the William Webb Ellis trophy). Economic growth, as measured by real gross domestic product, was negative in the third quarter at -0.2% quarter-on-quarter, meaning that full-year growth will probably be below 1% (we'll only get the final numbers in March).

This is by no means the catastrophic outcome many expected but is clearly not much to write home about. The SA economy is deeply constrained by unreliable infrastructure and inefficient public services and crawls along – but it is not collapsing. It will struggle to beat 2% growth on a sustained basis until there is meaningful progress in crowding in private sector participation in rail, ports and electricity.

One silver lining: with the domestic inflation outlook generally improving and the global interest rate environment turning, the SA Reserve Bank is likely to start cutting rates in mid-2024.

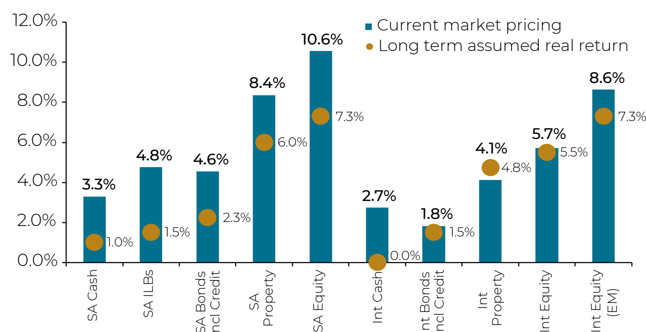
## LOOKING AT VALUATIONS

Finally, given that we really cannot predict the future despite our best efforts, it is important to spend most of our time making sure that our portfolios are appropriately diversified and positioned for a range of possible outcomes. Just as 2023 started on a pessimistic note and ended with unexpectedly strong returns, the opposite is possible given the prevailing optimism at the start of 2024.

Asset class valuations play an important role here. When an asset class is cheap relative to history, it tends to deliver better subsequent real returns, provided investors are patient. In contrast, asset classes with above average valuations tend to deliver below-average returns.

Chart 3 summarises asset class valuations (expressed as real yields) compared to the long-term expected returns that go into our strategic asset allocation modelling. In simple terms, where the bar is above the dot, an asset class is attractive relative to what one would normally expect it to deliver.

**Chart 3: Current and long-term expected returns**




Source: Old Mutual Multi-Managers

Clearly there is a lot of value in South African assets, and reasonable value internationally. We will continue to carefully balance these risks and opportunities in 2024.