M&G Insights

M&G Investments

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Return outlook still positive despite higher uncertainty

Following Russia's tragic and destructive invasion of Ukraine, we are seeing gathering headwinds to economic growth and asset returns amid the consequent jump in energy and commodity prices, as well as market volatility. Even before this, uncertainty was elevated due to rising inflation and questions around global central bank monetary policy. Also, importantly, starting valuations for SA equities were more expensive at the start of 2022 than they were at the beginning of 2021.

However, at M&G Investments, even though we are very concerned about these developments and are closely watching them, we still see many good opportunities to add value to investment returns across most SA asset classes over the medium term. This view is based predominantly on the fact that, even though our asset valuations did rise last year, this was off a very cheap base and those gains lagged many other markets in terms of both their absolute level and re-rating. Negative investor sentiment has weighed heavily on our local assets for many years, and this presents opportunities for further good returns going forward. In the current conditions, investors should focus on ensuring that they add securities at the right price, and also that their portfolios are very well diversified across sectors, geographies and asset classes. After all, no one can know what the Ukrainian conflict will eventually entail or how long it will last. There are myriad different outcomes, so it makes sense not to concentrate investment portfolios on only a narrow set of potential outcomes.

Currently, SA equity is our preferred asset class in our multi-asset portfolios, given how cheap valuations have been on both a historic and relative basis, especially versus US equities. Despite February's market turmoil, local valuations were barely changed: as of 28 February 2022, the FTSE/JSE Capped SWIX's forward price-to-earnings (P/E) ratio was still attractive at around 10.1X, while on a trailing price-to-book (P/B) valuation measure, its level of 1.90X is also cheap compared to its longer-term median level of 2.1X. In our view, the market is overly pessimistic about SA companies' expected performances - there are many excellent businesses in South Africa like banks, retailers and miners that have demonstrated solid long-term profitability, and we believe many have the potential to deliver strong results going forward, with earnings and dividends showing a robust return to growth over the medium term.

Many mining companies continue to experience elevated revenue and earnings as the prices of commodities remain at high levels, helping them strengthen their balance sheets as well as enabling large dividend payments to shareholders. These high commodity prices are supportive not only for the companies mining them, but also for the wider South African economy via growth, higher tax revenues and added consumer spending.

We are particularly excited about the return potential from our overweight positions in SA banks: Standard Bank, Absa and Investec are among the top 10 equity holdings in the M&G Balanced and Inflation Plus Funds. Banks benefit from a rising interest rate cycle as long as its pace and extent remain relatively moderate. By contrast, we are underweight insurers, where Covid-related claims and business disruption remain a risk. We also prefer SA equities to property counters in our portfolios due to the continued structural challenges the listed property sector faces, such as oversupply in the office space, rising interest rates and negative rental reversions.

Meanwhile, we believe local nominal bonds present investors with an attractive opportunity to earn lucrative returns over time. Government bonds were well supported following the good-news 2022/23 National Budget, particularly in longer-dated maturities, while shorter-dated debt has weakened amid rising interest rate forecasts. We believe the yields on 7-12-year government bonds, in particular, remain attractive. For example, the current 10-year real yield of around 6.1% is still well above our long-run fair value of 3.0%. We believe this will adequately compensate investors for the now-greater risks of higher inflation going forward. So far, actual SA inflation and inflation expectations have remained relatively subdued compared to many other countries, and within the SARB's 3-6% inflation target band.

Global sovereign bonds are still offering investors negative real yields as a result of the historically deep interest rate cuts made by global central banks during the pandemic, and we are underweight these assets in our multi-asset portfolios. We also hold more SA government bonds and fewer SA corporate bonds than usual, given that there's little need for us to take on the additional credit risk at the current elevated yields on offer.

SA cash continues to be an unattractive investment option for now. This is because of the very low base off which our rates are rising – leaving potential cash returns much lower than those from SA equities and SA bonds. As local interest rates rise, cash should become more attractive again. However, based on the SARB's projections, it will take time before it becomes a viable option for longer-term investors. Given the large shift of local investors into cash over the past 3-5 years, investors will need to reassess their cash holdings very carefully.

In conclusion, despite all the risks – both known and unknown – presenting themselves so far in 2022, we believe SA equity and bond valuations remain attractive, and have the potential to deliver strong returns over the medium term. South African investors have an opportunity to continue to reap the benefits of well-priced assets across a variety of asset classes. This makes multi-asset funds a particularly appealing option in the current environment, and we believe M&G's client portfolios are well positioned to take advantage of these conditions. Investing in attractively priced assets, along with appropriate diversification, should help to limit the downside that comes with volatile market conditions. As valuation-based investors, we continue to focus on the fundamentals, and on ensuring that we actively manage client portfolios to avoid any new risks or take advantage of opportunities that may emerge in the current uncertainty.