M&G Insights

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Comment on: Inflation, interest rates and portfolio positioning

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A major factor driving losses in global and (to a lesser extent) local investment markets so far this year has been concern by investors that persistently high US inflation would lead the US Federal Reserve to raise interest rates more aggressively than expected. The resulting macroeconomic slowdown could tip into recession, perhaps even globally when considering the current weakness of the Chinese economy resulting from rolling Covid lockdowns. A delicate policy balance is required to hike interest rates sufficiently to lower price pressures without cutting off economic expansion.

Many investors are wondering how we are looking at the current environment, how we are positioning our portfolios to best exploit market conditions, and if we still believe our funds will be able to meet their expected returns over the medium term. Here we aim to address these questions for our clients.

Forecasting inflation?

In our view, while the topics of future inflation and economic growth are very important, they are very difficult forecasts to make. As many clients will know, we believe it is impossible to do so with any degree of accuracy, or to out-forecast the broader market. For example, on the topic of inflation, we can find many good reasons as to why we are headed toward a higher inflationary environment… just as we can find many good reasons why the current high inflation might be transitory.

Inflation might endure longer than the market thinks due to the strong wealth effect which has been driven by both loose monetary and fiscal policy. Asset and commodity prices have responded by rising sharply, and labour shortages have become common in many sectors and countries: Job openings in the US are at an all-time high, at over 10 million, and employers have responded by offering higher wages. Central banks are concerned these forces could become embedded in higher inflation expectations, consequently ending four decades of a broad downtrend in structural inflation.

Equally, good arguments can be made for inflation to be transitory. The world economy suffered a major shut-down during COVID, and it is only natural to expect that such a globalised economy is going to take time to bring back online again. One must expect logistical issues and bottlenecks as countries resume operations and power up to working efficiencies. A slow power-up in certain countries or regions might impact global supply chains. We are also cognisant that because the global markets are already concerned about inflation, they may already be embedding expected inflation in commodity prices. That is, the commodity prices today might already have factored in future high inflation. If inflation is transitory and expectations start to fall, we may see commodity prices start to normalise, with a commensurate impact on inflation.

The fact is that we don’t know what the future holds. What we do know is that the market is grappling with the significantly higher interest rates that have been driven higher by expectations of higher inflation. Higher rates spell slower growth, and that could challenge company earnings. Weaker growth creates fiscal pressures which impact emerging economies like South Africa disproportionately.

Against all this uncertainty, the main question we spend a lot of time debating is: **to what extent are asset prices factoring in these concerns and issues? Are we at a point where we are being rewarded with a significant enough risk premium to own**

equities and other risk assets? And the related question: **Should portfolios be increasing their exposure to offshore assets to protect themselves against a global slowdown and increasing investor risk aversion?**

Our value added

We firmly believe that the main value that we can add to our clients during uncertain periods such as this, is to not try to predict what the future may hold, but to construct portfolios which have the best chance of outperforming their benchmarks under many different scenarios. When we construct our portfolios, we do not do so based on a particular view or outcome, as we think it is not possible to consistently predict what inflation rates might do… or when and where countries may go to war or cease war, for instance. One could make good arguments for both why the Russian invasion could end quickly, and why it might drag on. We do not know which outcome is more likely, nor does anyone else. We rather look to construct portfolios with many different and diversified ideas underpinned by favourable valuations -- portfolios that we believe have the best chance of delivering the market-beating returns over the long term that our clients have both enjoyed in the past and expect in the future.

Looking to higher-quality, well-valued companies

We aim to try and make money for our clients through these cycles and to try and buy companies that have proven dividend and cash flow track records, which can withstand the normal upheavals that occur in markets over time. There are many high-quality SA companies with sound business models and strong, well-capitalised balance sheets that are trading at undemanding valuations.

In this type of environment, companies which own high-quality assets and with strong pricing power are generally the types of companies that may start to attract higher ratings, as they are more likely to be able to offset the inflationary cost pressures which are arising. Good capital allocators and companies that focus on cash returns are likely to do well. Finally, and most importantly, companies that are well-valued and are not priced for the hope of future growth are also likely to fare better.

We also spend a lot of time thinking about **the economic cycles that various sectors are experiencing, and where valuations are relative to this**. We note, for instance, that within the South African market, many commodity companies continue to experience elevated revenue and earnings, as the prices of platinum group metals, coal and iron ore remain at high levels. These strong commodity prices are not only helpful to the companies mining them, but are also broadly supportive of the South African economy through their tax revenues and employment.

While we acknowledge that commodity prices and margins may be elevated, we are also cognisant that valuations are not expensive. It appears that, unlike the period before the 2008 Global Financial Crisis (GFC), the market is valuing commodity companies at reasonable levels, and we can buy high-quality commodity companies at very good prices.

We are also aware that in strong commodity cycles such as the present, many other South African industrial and financial companies could benefit from its knock-on effects. We have therefore increased our exposure to certain SA economy-focused stocks at excellent valuations, as some share prices have fallen to levels even lower than those seen during the GFC.

SA equities and bonds offering ample reward for risk

In broad terms, we remain optimistic regarding the South African equity market's returns over the medium term due to the prevailing excessive levels of pessimism reflected in share prices and valuations. Going into the Covid-19 crisis, the South African market in our view was already undervalued, and continues to trade at levels which we think are exceptionally attractive. The Price to Book (P/B) value ratio of the JSE remains under 1.7X as at the end of April 2022 compared to its longer-term average of around 2.1X.

The same is true for the South African bond market. For example, the yield on the SA government's nominal 10-year bonds, at 10.2%, imbeds the view that SA inflation will remain well above 6% for many years to come. This is despite the South African Reserve Bank's strong track record of keeping core inflation below the upper level of its target 3%-6% band since 2010, as well as the evidence of lower inflationary pressures in the local market currently due to factors like our low economic growth and high unemployment levels. South Africa's latest CPI inflation rate was reported at 5.9% y/y, compared to 8.5% y/y in the US. Equally, local inflation expectations are proving resilient: survey data across consumers, business and the unions are all still below the top of the SARB's 6% inflation target band.

Based on the current valuations, we think that there is an adequate margin of safety in both the SA equity and bond markets to compensate for many of the risks in this environment. Fear of inflation and lower growth appear to be at the top of investors' minds.

Considering US dollar strength

It is worth pointing out that the US dollar has been exceptionally strong since the start of the year. The dollar has appreciated by over 10% as measured by the DXY Index, which represents a basket of major currencies against the USD. We think that the dollar is being seen as a safe-haven currency. During threats of war and instability, we would normally expect the gold price to be seen as a safe-haven as well, but the increasing interest rates make gold less attractive and the dollar relatively more attractive. The stronger US economic growth is also seen as a potentially comforting factor to investors (although recent data indicates some loss of economic traction).

The strong dollar is having a different impact on many non-US countries, however. Countries or regions most at risk from a strong dollar are those emerging markets with high levels of external US dollar-denominated debt, and those importing ever increasing-inflation in the form of higher food and energy prices. Developing countries that produce dollar-priced commodities may be seen as relative beneficiaries of the strong dollar, although they are also likely to experience rising inflation and pressure on consumers. South Africa exports dollar-priced metals and minerals, but it also imports dollar-priced oil. While both export and import prices have risen for us, the economy has been a net beneficiary because the former has increased significantly more since the end of 2019. South Africa also has relatively low levels of US dollar debt compared to some of its developing peers. This may, in part, explain the outperformance of the rand against a number of other emerging markets and also have assisted in holding South African inflation below that of many other countries. As always, investing is a relative game, and it is worth noting that these large global inflationary pressures and considerable relative currency movements may start to expose the weaker countries and regions.

Multi-asset portfolio positioning

In our view, the SA market is pricing in far higher risk premia for SA bonds and SA equities currently than is merited by the likely outcomes for inflation and interest rates. Our equity market is trading on a Price/Book value ratio half that of the S&P 500. Many SA companies are offering dividend yields in high single-digits, while South African bonds offer yields more than 7% above their US counterparts. In our multi-asset funds we have responded to these attractive valuation characteristics through increasing our exposure to these assets, in the main using cash we had in portfolios. In a few cases, where cash wasn’t available, we have sold property assets to fund better ideas. Consequently, we are broadly overweight SA bonds and equities in these funds.

Regarding SA listed property, our analysis indicates that as an asset class it is cheap relative to its long-term fair value levels, but less so than other domestic assets. It performed very well in 2021, benefitting from the growth rebound, low interest rates and improving balance sheets across the sector. Property distribution yields of 9% are decent and imply low double-digit absolute returns over the medium term. On a risk-adjusted basis, however, we see better opportunities in SA bonds and equities.

To conclude, in the current environment we continue to rely on asset valuations to inform our portfolio construction decisions, as well as excellent diversification both across and within asset classes to mitigate downside risks. Our equity holdings comprise many strong companies. In our house-view multi-asset portfolios we remain overweight offshore cash and underweight offshore bonds, and have recently lifted our offshore equity exposure to neutral from underweight as a result of the recent sharp global sell-off. In the local market, SA equities and bonds are our preferred asset classes, while we are underweight SA cash and broadly neutral-to-underweight SA listed property, depending on the portfolio. Given the excellent valuations at which we bought most of these assets, we are confident that our portfolios remain well-positioned to reach their investment goals over the medium term and meet our clients' expectations.