M&G Insights

M&G Investments

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Investment Focus: Market valuations support strong return outlook

A patient approach and long-term outlook were required in August as both global and local asset returns were broadly negative. Our M&G funds' favourable offshore positioning, still leaning into global cash and away from global bonds and equities (the latter to a lesser extent), helped cushion the downside.

In the local markets, losses in SA equities detracted from our fund performance, but these were offset to some extent by stock selection, our SA bond overweight and our underweight in SA listed property. Stocks adding value included Absa, Exxaro, Foschini and BAT, while among detractors were MTN, Sappi, Northam Platinum and Sasol.

SA asset valuations cheapened towards month-end, with current levels indicating strong double-digit prospective returns from both SA equities and bonds over the next three to five years. Of course, no one knows when exactly these returns will materialise and in what fashion, but they provide a healthy margin of safety that should reward investors well for the risks they are taking.

Breaking this down further, the FTSE/JSE Capped SWIX's trailing price-to-book value (P/B) measure -- at 1.56X as of the end of

August -- was trading at about a 25% discount compared to its longer-term median of 2.1X. Despite this cheapness, we opted to maintain our 2%-2.5% overweight in SA equities in our best house view portfolios as, given the increased global risks to company earnings and economic growth, we would want to see further de-rating before adding any more.

At the same time, the benchmark 10-year SA nominal bond saw its yield rise to around 11.0% p.a., which would give investors a real yield of around 6.5% p.a. when discounting 10-year inflation averaging 4.5% y/y. This is more than double its long-term fair value of around a 3.0% p.a. real yield. Additionally, compare this to the current SA cash yield of 5.8% p.a. (over 10 years) and the 10-year US Treasury nominal yield of 3.3% p.a., offering no real return. Amid expectations for the SA Reserve Bank to continue its aggressive rate hiking cycle to keep step with the US Federal Reserve, nominal bonds offer a sound fixed-income option for weathering the turbulence. As such, we kept our large overweight in SA bonds, but did not add to our position based on the potential risks of rising global inflation and interest rates.

In the listed property sector, valuations using the consensus forward distributable earnings yield of 10.5% p.a. are also cheap compared to their longer-term fair value yield of 6% p.a.. However, we remain cautious with a neutral positioning in our portfolios given persistent concerns about the sustainability and quality of future distributions, the length of the current perceived earnings rebasing cycle and the continuing balance sheet repair needed as a result of the COVID-19 pandemic.

Although investment conditions have been deteriorating amid expectations of higher global interest rates and slower growth, this is part of a broader market cycle that will eventually turn for the better. We have already seen global food inflation slowing and some supply bottlenecks easing, with inflation thought to have now peaked in the US, although energy prices remain high.

At M&G Investments we always manage our clients’ funds with the goal of performing through full market cycles, both the up and the down, and we are still confident that our funds are on track to meet their goals based on the excellent valuations at which we've bought our holdings.

Patience is what is required now to weather the current downturn, taking advantage of selective opportunities until the Fed signals an end to its rate hiking cycle.

For more information, feel free to contact our Client Services Team on 0860 105 775 or email us at info@mandg.co.za.