M&G Insights

Offshore investing risks in 2024

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At M&G Investments, we don't pretend to have a crystal ball to be able to forecast the future, instead building our portfolios based on current asset valuations. In our view, these valuations are telling us that South Africa is the place to be in 2024 rather than offshore, and particularly not in US equities.

Of course, strong portfolio diversification is required across markets and asset types to achieve an appropriate risk/return balance, but local asset valuations are compelling versus their offshore counterparts. South African equities started off the year at a very cheap 12-month forward price/earnings (P/E) ratio of 8.9X, and this has remained low during the year, currently at 9.5X. Compare this to US equities at over 19.0X, the MSCI All Countries World Index (ACWI) at 16.8X and the MSCI Emerging Markets Index at 11.4X at present. The US is quite expensive versus other markets and has kept the ACWI elevated as well, largely due to the handful of companies whose future growth is being driven by the application of artificial intelligence (AI) – the so-called "magnificent seven".

Based on these starting valuation points, we would expect SA equities to have a better chance of outperforming global equities over the medium-term. Sentiment towards South Africa is very pessimistic, in our view, with the market pricing in outcomes more in line with previous periods of global recessions and financial crashes than what is justified in the current conditions. This is adding a degree of safety to local equity investments that is not present in global equities.

Turning to bonds, currently South Africa's 10-year government bonds give investors a real yield of over 6%, much more attractive than that of 10-year US Treasuries at under 3%. SA real bond yields are more attractive than those of many other countries and are elevated relative to their estimated long-run fair value of 3%. Our view is that SA nominal bonds offer much better prospects of delivering positive real returns than global bonds. While local bonds do present elevated risks, current yields are pricing in an unlikely scenario of local inflation remaining above the SA Reserve Bank's 3-6% target range, despite the SARB's strong track record combatting inflation. In our view, current yields more than compensate investors for the associated risks, and patient investors will be well rewarded.

However, global bonds are now offering relatively attractive real yields compared to recent history, and serve as effective diversifiers for SA equity risk. As in global equities, we are neutrally positioned due to the risks associated with global inflation and high interest rates. More specifically, we have been holding 30-year US Treasuries, German bunds and UK gilts now that yields have risen to more appropriate levels, as well as selected sovereign emerging market bonds where the real yields are high and the currency trading at fair-to-cheap levels.

Looking ahead, several factors have the potential to provide tailwinds for SA equities and bonds in the new year, including lower inflation, a continuation of responsible fiscal policy, infrastructure improvements, and the start of interest rate cuts both globally and locally. The local bond market's rally following the better-than-expected Medium-Term Budget Policy Statement, and its outperformance of global bonds in the recent global rally, are examples of how SA assets have the potential to rebound as a result of any good news.

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