M&G Insights

Investing through uncertainty

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Have you ever played the board game 'Settlers of Catan'? It starts off as a bare island with some abundant and some scarce resources, which you must trade to grow your economy. You compete to build roads, settlements and cities and the winner is most often the player who has created the fastest growing and most efficient economy. Trade - the exchange of goods and services - is what causes economies to grow.

Before the days of trains and ships, trade occurred mainly overland, but affordable air and sea freight and the invention of containers have dramatically lowered the cost and risk of trading goods. The ability to trade at lower costs and risks around the world has led to much greater trade and, as a result, much stronger growth and a much better standard of living for the world relative to just 100 years ago.

Here, we'll share insights and our approach to navigating the current global trade war, as well as the uncertainty being experienced locally over the future of the GNU, based on the situation at the time of writing.

Global environment - US tariffs are raising the cost of doing business

Tariffs that the US is imposing on its trading partners have come at a time when the US has been growing at rates for over a decade that, in many cases, have been a lot stronger than many of its trading partners. US unemployment rates are close to 4%, reflecting almost full economic employment. Up until a few months ago, the S&P 500 had reached all-time highs and is one of the best performing developed equity markets over the last decade, with its earnings handsomely outperforming most markets. So, why would the US be wanting to impose tariffs now on all its trading partners? Is this a negotiating tactic or a case of trying to squeeze the last juice?

One argument might be that the US wishes to increase its manufacturing base and bring back jobs to the US. The problem with this argument is two-fold: Firstly, the US is already close to full employment and would need to source labour from parts of the economy where it's already employed. Secondly, the success of the US has meant that it has been able to transition to more of a services and knowledge-based economy, which often has a much higher rate of return for all stakeholders.

The US has relocated its labour and capital away from manufacturing into services where salaries and wages are often higher. You can see the country's success in services in its balance of payments where it in fact receives a net payment from trading partners for services provided such as IT and AI.

There are several reasons the US might wish to impose broad-based tariffs, but it is difficult to know the ultimate intent or outcome. What is clear is that the level of uncertainty in the market has gone up. The tariffs against most of the US trading partners will be causing countries to be questioning the word "partner". We're already seeing countries such as China imposing targeted retaliatory tariffs against the US.

South Africa – A testing time for the GNU

While this global turmoil and the associated volatility has affected assets around the world, the South African political developments unfolding simultaneously have only added to investors' concerns. Parliament's adoption of the 'redrafted' national budget without the support of the DA has significantly increased the risk that the GNU unravels in its current form.

Investors have been left to contemplate many possible scenarios: Will the GNU survive in its current form? If it does survive, has its ability to deliver on the reform mandate been compromised? Would its composition change if the DA exited, being replaced instead by a multitude of smaller parties and a wafer slim parliamentary majority? Would the ANC seek to align with the EFF or MKP instead?

With the eventual outcome remaining unclear, the downside risks have increased materially, and South African asset prices have repriced as a result. Volatility in domestic asset prices is set to remain elevated while this uncertainty persists.

Our approach through uncertainty

We understand that the market volatility and noise that we're currently experiencing is overwhelming for many investors. It's natural to feel some discomfort with this level of complexity and uncertainty. While we're fully aware of the intensity of the current market environment, staying true to our longstanding investment philosophy is key to navigating times like these. We strongly believe this approach leads to sustainable investment performance for our clients over time:

Asset allocation

Our tried and often-tested approach of using valuations as an anchor, around which we apply an episodic tactical asset allocation framework, comes into its own during times like these.

We acknowledge the potential damage to both growth and inflation that could be wrought by Trump's tariffs, as well as how surprised the market has been by the announcements on 'Liberation Day'. It highlights why it's not useful to try to predict every individual policy or political event for portfolio positioning. We and the market simply do not know what the future holds, how asset prices will react and the impact on our clients' portfolios. Our approach, based solidly on medium to long-term valuations, overlaid with short-term price and behavioural observations, tends to be more fruitful, especially in times of stress.

At the asset class level, we entered this market environment broadly neutral equities and long bonds. Within equities, our underweight in US equities, based on valuations, enables us to be patient and engage in the market when opportunities present themselves. This is further enhanced by the diversification offered by our long developed-market government bond positions.

Impact on companies

As equity investors, a key consideration is how companies' future cash flows could be potentially impacted by the tariffs' uncertainty. It's often companies with high-quality assets and strong pricing power, with the ability to push through price increases to their customers, that are likely to be less effected. However, in an environment where countries might broadly (arbitrarily or in retaliation) impose tariffs, it makes the assessment of future cash flows more uncertain, even for companies that may have been considered high-quality.

For those running a business, it's an incredibly difficult environment in which to operate, no matter where in the world you are operating from. For example, a mining company in South Africa making large investment decisions for the next few decades is more likely to delay or reduce any large investment decisions. The uncertainty and delay around investment decisions may cause a slowdown in growth in the US, its trading partners and across the world.

Tariffs can distort markets, are a blunt instrument (especially where instituted broadly) and are very likely to have unintended consequences. For instance, even where a US miner might be the beneficiary of a tariff on a metal, why build a mine for the next few decades based solely on a tariff that could just as easily be removed by the current or future US administration?

When evaluating the future cash flows of a business, it is also important to consider both the operational and financial leverage within the company. A combination of both high operational and financial leverage can be fatal to a company in a recessionary environment - The risk of company bankruptcies is rising.

Uncertain environments not only mean more difficult times through which businesses need to operate, but also that investors increase the risk premium they require to invest in companies as the uncertainty and volatility around future cash flows increases.

There are, however, many high-quality South African companies with sound business models and strong, well-capitalised balance sheets that are trading at undemanding valuations.

Conclusion – Investing in uncertain times

The key for us will be whether markets are likely to under or overreact as they digest news and its implications. Where panic begins to take over, it's often more likely that markets overreact in a negative manner. We're mindful of this and will continue to watch patiently for evidence of a behaviourally driven narrative, where prices themselves begin to drive asset markets into a spiral that may become an overreaction.

It is too early to draw significant conclusions on tariffs or the GNU. Given the relatively low levels of active risk across our portfolios (multi-asset, equities and fixed income), with no significant directional view at the asset class level in equities and modest active exposure in both South African and global bonds, we're in a position to continue to observe events as they unfold, with sufficient flexibility to add attractive assets opportunistically. We are, however, mindful of the possibility of further market surprises and are ready to take advantage of opportunities that arise.

While we navigate this complex market environment, we continue to stay true to our long-term, prudent, valuation-driven investment philosophy supported by rigorous risk control. We strongly believe this approach leads to sustainable investment performance for our clients over time. As a client, you can take comfort in this and being invested with a trusted global investment manager that puts you first.

We truly appreciate your continued support, and we remain dedicated to delivering consistent investment outcomes for you. Please reach out to us should you require any further details.

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