

INVESTMENT NOTE

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SHOCKTOBER



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OLD MUTUAL MULTI-MANAGERS

As South Africans cheer the incredible performance of the Springboks and a record fourth Rugby World Cup title, they might forget the fact that October has been a lousy month for investment returns, particularly South African equities. In fact, it has been a bad year, with 2023-to-date returns on the FTSE/JSE Capped SWIX Index under water with only two months and two days left to go.

What went wrong? South African economic growth has turned out to be better than expected, along with many other parts of the world, particularly the US. Shouldn't the equity market reflect this happier turn of events? Better economic growth tends to mean better earnings growth.

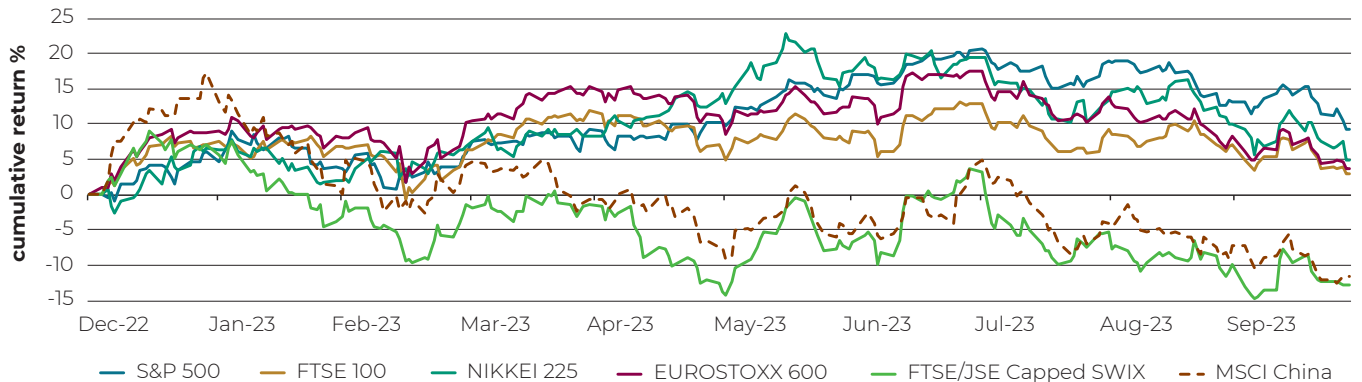
The problem is that unexpectedly strong US economic growth has put upward pressure on interest rates (bond yields), and this has put downward pressure on equity ratings. October has therefore been a rough month across global markets, with most indices in the red.

Though most major markets are still positive this year, none are shooting the lights out. The US S&P 500 has been the best performer, but most of these returns come from the 'magnificent seven' technology companies. Japan is having a strong year, but yen weakness substantially cuts the dollar return. China has been an outlier among major markets. It started the year on the front foot, but the optimism around reopening from lockdowns evaporated quickly. The fact that the return profile of the FTSE/JSE Capped SWIX looks a lot like the Chinese market is no coincidence.



WEALTH

CHART 1: GLOBAL EQUITIES IN 2023 IN US DOLLARS

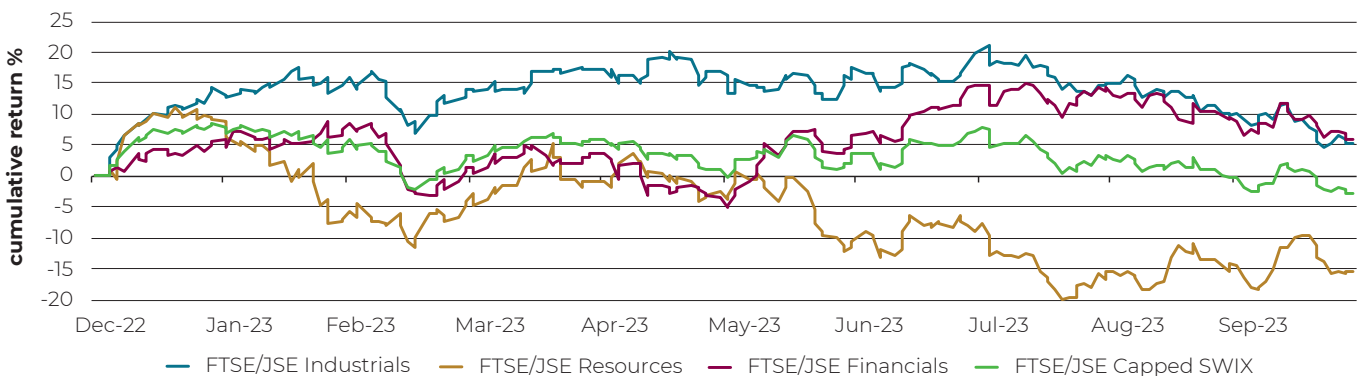


Source: LSEG Datastream

JSE-listed equities are traditionally grouped in three sectors: industrial, financial and resources. These names are not entirely accurate anymore, nor is it the best way of slicing

and dicing the market, but it does offer a simple way of thinking about things.

CHART 2: JSE SUB-SECTOR RETURNS IN 2023 IN RANDS



Source: LSEG Datastream

Industrials are not really 'industrial' anymore. The sector is dominated by consumer-facing companies, and notably the likes of Naspers and Richemont who make their money outside South Africa, particularly in China.

The resources sector had a decent month, but lost 15% this year, and is responsible for the overall JSE trading in negative territory. Recent commodity price movements have been unfavourable. The palladium price has lost almost 40% this year, and platinum around 12%. Coal is also almost 40%

lower. The gold price jumped in the wake of rising geopolitical anxieties in the Middle East, but gold mining is a small sector on the JSE these days.

In contrast, the financial sector is still in positive territory year-to-date. Of the three, it is the most SA-focused, immediately telling us that it is not just South Africa's long list of own goals that is behind the disappointing returns.

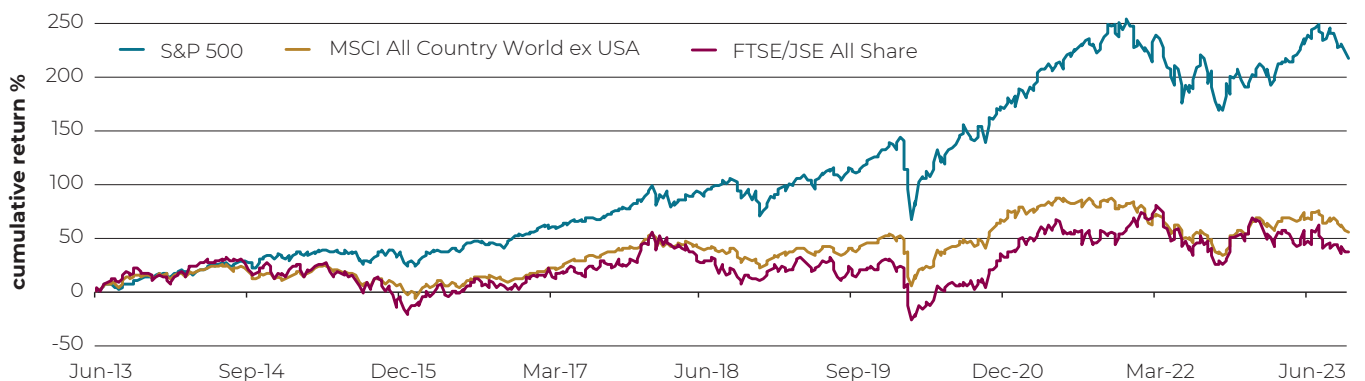
MUTED RETURNS

What about the longer-term picture? At the end of September, the five-year total annual return on the FTSE/JSE Capped SWIX was 6.4%, a percent ahead of cash. The seven-year return was muted at 5.4%, in line with cash and inflation. The 10-year return was a bit better at 7% per year, ahead of cash and inflation. These are not catastrophic numbers by any means, but they do mean investors endured a lot of volatility for returns that are not much better than cash (if we ignore tax implications). If you are saving for retirement, this picture shouldn't alarm you too much. As the market gets cheaper, you are buying more with each regular contribution (known as rand cost averaging). The big problem lies with investors who are already drawing an income from their portfolios and experience the opposite of rand cost

averaging. Fortunately, higher interest rates mean retirees have more options for earning income than in recent years.

In dollar terms, South African equities have basically moved sideways over the past decade. No wonder foreign investors are disillusioned. But it should be noted that South Africa hardly stands out in this regard. As chart 3 shows, it is only the US that has delivered meaningful returns over the past decade, with the S&P 500 returning 11% per year. The rest of the world, represented by the MSCI All Country World ex-USA Index, only delivered 3% per year in dollars. South African equities have broadly performed in line with non-US global markets in dollar terms.

CHART 3: US AND NON-US EQUITY RETURNS IN DOLLARS, %



Source: LSEG Datastream

This is partly because the big technology platform businesses, and more recently semi-conductor designers, are largely US-listed businesses. The key thing about these businesses is that they have a growth story that is largely independent of how the broader economy performs, since they basically invented new industries (online search, social media, cloud computing, artificial intelligence). In contrast, traditional

cyclical businesses do well when the economy does well, and struggle when it does not.

Not only have these technology companies grown their earnings strongly, investors have also been prepared to pay more to own them, as reflected by the forward price: earnings ratio on the S&P 500 rising from 13 to 18 over the past decade.

THE BIG DERATING

In contrast, South African equities have experienced a massive derating over the same period. Earnings growth has been in line with the long-term average, but the forward PE ratio has steadily declined from a peak of around 16 in 2015 to just 9 today.

To put it slightly differently, investors are prepared to pay less for each rand's worth of earnings they can claim as

shareholders today than a few years ago. You might expect PE ratios to be constant. A rand of profit is a rand of profit, after all. But no, they move around all the time as investor sentiment waxes and wanes.

And in the case of South Africa, it has waned.

However, South Africa is not unique. Consider that the forward PE ratio on the MSCI Latin America Index has followed a similar trajectory, declining from 15 to 8. This is a region that shares many of the social, political and governance issues we have in South Africa, as well as our commodity dependence.

A lot of the negative investor sentiment towards South Africa therefore is not necessarily a vote of no confidence in South Africa and its specific problems, but rather investors shying away from the general set of conditions South Africa shares with other countries and regions, namely a lack of consistent economic growth and a lack of exciting fast-growing companies.

This is not to say that South Africa's problems aren't weighing on local equities. For instance, the coal miners have lost billions in rands in revenues due to the failures at Transnet.

SHRINKING MARKET?

Then there is the question of the large number of de-listings from the JSE, a concern since investors always prefer more shares to choose from. It is also worrying from the point of view of the economy. Equity markets connect those who have capital to invest with those who need capital to grow. If firms are shying away from the JSE, where do they go to for funding?

This is a bit of a chicken and egg situation. In the current sluggish economy, there aren't many businesses needing to fund big expansion plans. But without companies making these plans, we shouldn't expect much faster growth.

Part of the problem is when PE ratios are low, shares are cheap from the point of view of investors, but expensive from the point of view of the company issuing them to raise capital. Maintaining a listing also requires a lot of time and effort from executive management and can be costly. For some companies, going private might be an attractive option. Cheap companies also become takeover targets for others. Therefore, the de-listings are unlikely to be over, though there are still plenty of companies to choose from, and South African equity is not an endangered asset class.

This not only depresses their earnings, but also their ratings relative to coal miners in other jurisdictions. Another factor is that South African interest rates have increased over the past decade, particularly government bond yields. Higher bond yields should depress the ratings of companies that primarily generate their profits in South Africa, since it raises the cost of capital.

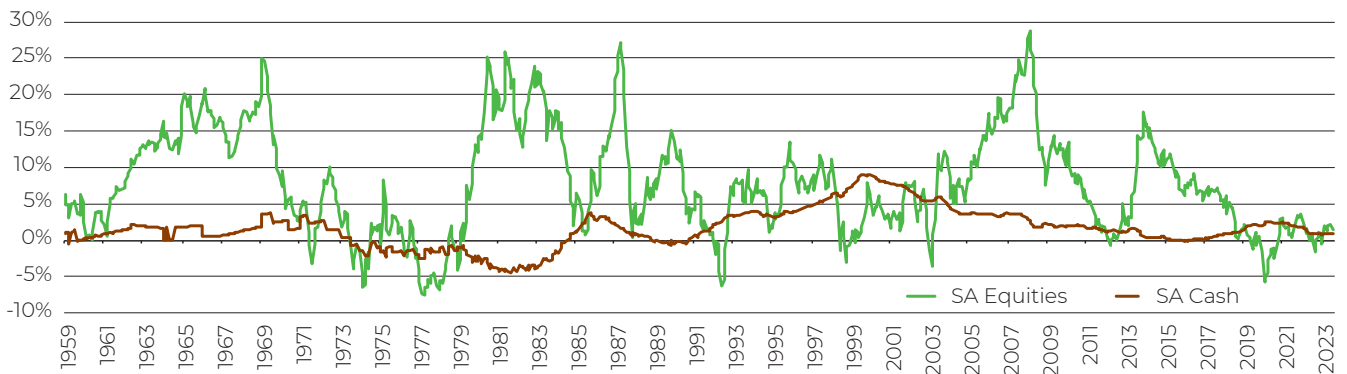
Therefore, for South African equities to perform very well from this point forward, we need a more favourable global environment. However, we also need to get our own house in order.

Now is not necessarily the time to give up. The big de-rating has already happened, and is very unlikely to repeat, with the JSE already trading at levels normally associated with recessions. This gives investors a substantial margin of safety.

Again, this is not a uniquely South African issue. There is a lot of soul-searching in the UK, for instance, over the lack of initial public offerings (IPO) in London, and even some stalwart LSE-listed firms are considering moving their listings to New York. A relatively depressed forward PE ratio (10 for the FTSE 100 against 18 for the S&P 500) means companies can potentially boost their share prices simply by moving to the higher rated market.

But even in the US, the number of listed companies has declined over time. Private equity, venture capital and other forms of private markets investing are large and growing asset classes globally, especially in America. Indeed, in the case of the US, there is a very well-established private funding ecosystem to support start-up companies, which is why the tech behemoths are mostly American.

Nonetheless, the pendulum will probably swing back again eventually. If ratings improve, we should see more companies listing on the JSE. The JSE itself is also looking at ways of reducing onerous listing requirements, no doubt spurred on by competition from new exchanges.

CHART 4: SA EQUITY AND CASH ROLLING 5-YEAR REAL RETURNS

Sources: LSEG Datastream, Iress

Finally, looking back at 60 years of SA equity returns in chart 4 – including long periods of political turmoil and tough economic times – shows a picture of big cycles of real returns. In most (80%) of the five-year periods shown since 1960, equities beat cash. But there have been long stretches of muted returns. The past few years do not stand out historically.

There are many attractively priced shares on the local market today, and there is every reason to believe future returns will look better. But the one difference between now and

in the past is that local investors have far greater opportunities to diversify offshore, including in retirement vehicles. No one needs to have all their equity exposure locally. What doesn't change is the need to always be patient when investing in equities. It is always a case of fat years and lean years, and to benefit fully from the former, one often must sit through the latter just as you had to sit through the nail-biting last 20 minutes of the final to see Siya Kolisi lift the trophy.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 732.0	-2.11%	-4.24%	4.96%	8.24%
United States	S&P 500	US\$	4 117.0	-2.53%	-3.99%	7.21%	8.14%
Europe	MSCI Europe	US\$	1 742.0	-1.02%	-4.55%	0.58%	11.10%
Britain	FTSE 100	US\$	8 838.0	-1.84%	-4.78%	-1.96%	8.06%
Germany	DAX	US\$	1 358.0	-1.16%	-5.10%	4.49%	16.67%
Japan	Nikkei 225	US\$	207.1	-0.72%	-2.92%	4.05%	10.78%
Emerging Markets	MSCI Emerging Markets	US\$	920.0	-0.65%	-3.46%	-3.77%	7.10%
Brazil	MSCI Brazil	US\$	1 528.0	1.53%	-1.74%	4.73%	-2.36%
China	MSCI China	US\$	56.4	2.49%	-2.89%	-11.87%	13.63%
India	MSCI India	US\$	799.0	-2.53%	-3.27%	3.63%	4.99%
South Africa	MSCI South Africa	US\$	361.0	-0.82%	-2.43%	-14.25%	-4.75%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	69 452.0	-1.06%	-4.05%	-4.92%	3.47%
All Share	All Share (Total Return)	Rand	12 204.0	-1.05%	-3.72%	-1.61%	7.30%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	29 673.2	-1.22%	-3.23%	-3.54%	2.34%
TOP 40/Large Caps	Top 40	Rand	11 115.0	-1.25%	-3.80%	-1.60%	9.10%
Mid Caps	Mid Cap	Rand	18 876.0	-1.02%	-4.71%	-4.95%	-5.79%
Small Companies	Small Cap	Rand	28 989.0	-1.06%	-3.65%	-1.32%	-0.48%
Resources	Resource 20	Rand	4 717.6	-2.49%	-3.00%	-17.88%	-8.13%
Industrials	Industrial 25	Rand	19 924.0	-0.02%	-4.95%	5.23%	20.66%
Financials	Financial 15	Rand	11 054.0	-1.38%	-3.89%	4.29%	3.77%
Listed Property	SA Listed Property	Rand	1 517.0	-0.98%	-5.25%	-10.34%	-4.35%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	72.2	0.29%	-1.11%	-6.18%	-2.73%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	884.9	1.03%	1.70%	3.19%	6.94%
Government Bonds	BESA GOVI	Rand	872.0	1.03%	1.69%	3.14%	6.90%
Inflation Linked Bonds	BESA CILI	Rand	327.5	-0.20%	-0.59%	0.40%	2.16%
Cash	STEFI Composite	Rand	540.4	0.16%	0.63%	6.51%	7.70%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	90.5	-1.82%	-1.65%	5.21%	-6.72%
Gold	Gold Spot	US\$	2 007.0	1.26%	8.55%	10.03%	20.69%
Platinum	Platinum Spot	US\$	902.0	0.78%	-0.22%	-15.94%	-5.05%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.84	0.80%	0.45%	-9.60%	-4.66%
ZAR/Pound	ZAR/GBP	Rand	22.84	1.27%	1.09%	-9.85%	-8.98%
ZAR/Euro	ZAR/EUR	Rand	19.90	1.18%	0.53%	-8.46%	-9.97%
Dollar/Euro	USD/EUR	US\$	1.06	0.00%	-0.28%	0.94%	-5.66%
Dollar/Pound	USD/GBP	US\$	1.21	0.35%	0.65%	-0.17%	-4.30%
Dollar/Yen	USD/JPY	US\$	0.01	-0.13%	0.21%	14.14%	2.30%

Source: I-Net, figures as at 16 October 2023

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WEALTH

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