

INVESTMENT NOTE

08 JULY 2024

UNITED AND DIVIDED



IZAK ODENDAAL

OLD MUTUAL WEALTH
CHIEF INVESTMENT STRATEGIST

Through fluke or design, the United Kingdom held its general election on the same day that Americans celebrate independence from Britain, the 4th of July. It turned out to be another historic day, but not for reasons the Conservative Party will want to remember as it suffered the worst electoral defeat since its founding in 1834. The defeat meant that after 14 chaotic years and five prime ministers, the Conservatives handed over power to Keir Starmer's Labour Party.

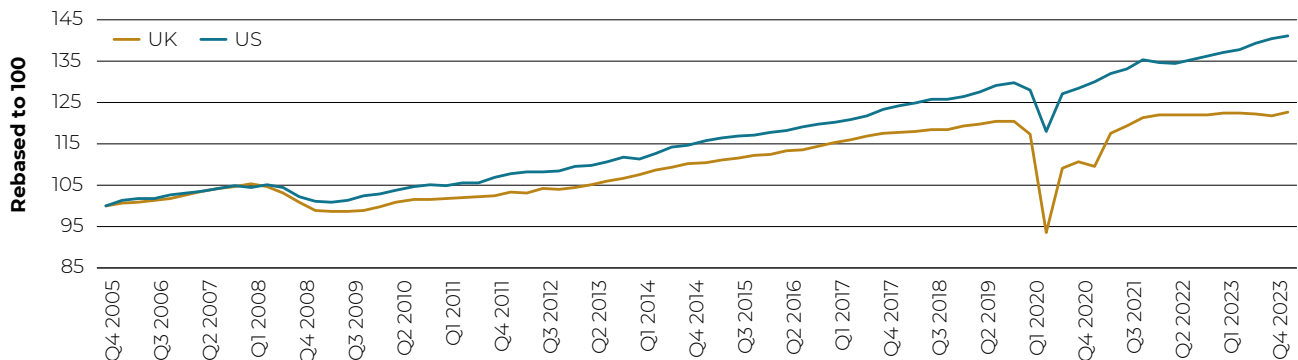
The UK and the United States share much in terms of culture and history, and as the old joke goes, are divided by a common language. Both are also thought of as bastions of free market capitalism, at least since the Reagan-Thatcher era of the 1980s. However, America pulled well ahead of its former colonial master during

the 20th century, when two world wars left Britain battered but the US re-energised. Things got so bad in Britain that it was forced to turn to the International Monetary Fund for a bailout in 1976. Today the US is not just a bigger economy due to its much larger population, the average American is also about a third richer.

What is probably underappreciated, however, is the more recent divergence in economic and financial market performance. As chart 1 shows, the UK had a slower recovery from the 2008 Global Financial Crisis, partly due to its outsized banking sector, and partly due to the tough fiscal austerity imposed by Conservative Party from 2010 onwards. It also had a deeper recession in the pandemic, and a slower subsequent upswing.



CHART 1: US AND UK REAL GROSS DOMESTIC PRODUCT



Source: LSEG Datastream

Underlying the weaker recovery from these two epochal events is much slower productivity growth. Over the past 20 years, average productivity growth in the US was relatively low at 1%, but in the UK the growth rate was just half that.

One similarity across the two countries has been rising inequality, including stark regional differences, and a turn towards populist politics. 2016 was the watershed year, when the British voted for Brexit and Americans surprisingly chose Donald Trump as president. However, it is only the former that caused notable and lasting economic change, and not

for the better. None of the supposed economic benefits of leaving the European Union have materialised, but the cost of abandoning free trade with one of the world's three mega-economies was substantial. Most countries trade more extensively with neighbours than distant economies, and the EU remains Britain's largest trading partner. But free and easy access has been lost, with nothing to offset it. Brexiteers hoped that the US under Trump would offer a free trade agreement, but that never materialised and is not even on the agenda in Washington today.

SAFE AS HOUSES

A problem both the US and UK face, and one that contributes to resentment of particularly younger voters, is the lack of affordable housing. Neither country has built enough homes for growing populations (even as population growth has slowed).

The problem is more acute in the UK, while in the US it tends to be concentrated in certain cities. In the US, the lack of sufficient supply is largely due to the post-financial crisis slump in building activity. This could revive if interest rates fall. In the UK, the onerous planning regime dating from 1947 is often blamed, and indeed was a key issue in the election. The Conservatives couldn't keep promises of building more homes, it remains to be seen if Labour can do better.

As basic economic theory would suggest, the lack of housing supply has pushed prices up relative to incomes. A Financial Times analysis recently showed that UK house prices are more expensive relative to income than any time since 1876. Rising house prices benefit homeowners, obviously, but they tend to be older and wealthier. Young people are frustrated as more and more of them are forced to live with their parents deep into their twenties, delaying starting their own families.

One key difference in the two property markets is that US borrowers benefit from being able to fix mortgage rates over 30 years. Therefore, most homeowners are shielded from the much higher interest rates since 2021. British home loans, in contrast, tend to be fixed for two years, and then adjust to prevailing market rates. This means a substantial increase in monthly mortgage payments for many.

The blow is softened somewhat by decent wage growth since unemployment rates remain low. In the US it is 4.1% and the UK 4.4%. The US added another 206,000 jobs in June and wage growth was 3.8%.

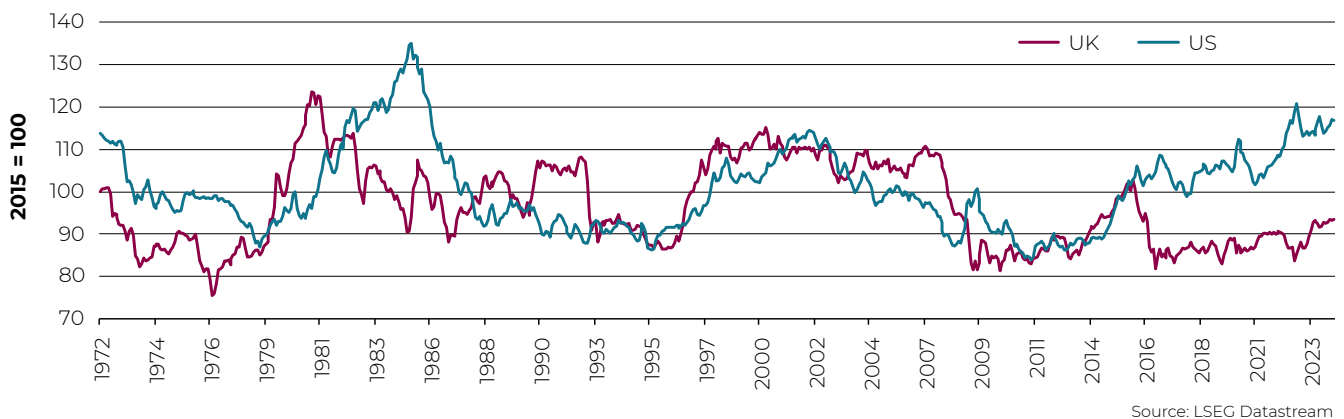
Speaking of low unemployment, as much as immigration is a hot-button political issue that contributed to both Brexit and Trump's 2016 win, both countries need immigrant workers. The median age in the UK and US is 40 and 38.5 respectively, and the birth rates of 1.5 and 1.6 are below the replacement rate. Therefore, virtually the entire net population increase in recent years has been due to immigration. Of course, the demographic dynamics in continental Europe are even worse, and arguably, so is the track-record of successfully integrating migrants compared to the Anglo-Saxon countries.

POUNDED

Another factor that links the two countries is that the role of issuing the global reserve currency switched between the two. Before World War I, sterling was the dominant currency. After World War II, the global economy has been running on the dollar system. Initially the dollar was backed by gold and most currencies were pegged, but from the 1970s onwards the world moved to market-determined

exchange rates. The dollar remains the dominant currency in terms of central bank reserves, financial market transactions, cross-border lending, and international trade. Other countries are trying to chip away at dollar supremacy, but it will be a slow process because the alternative currencies have significant shortcomings of their own.

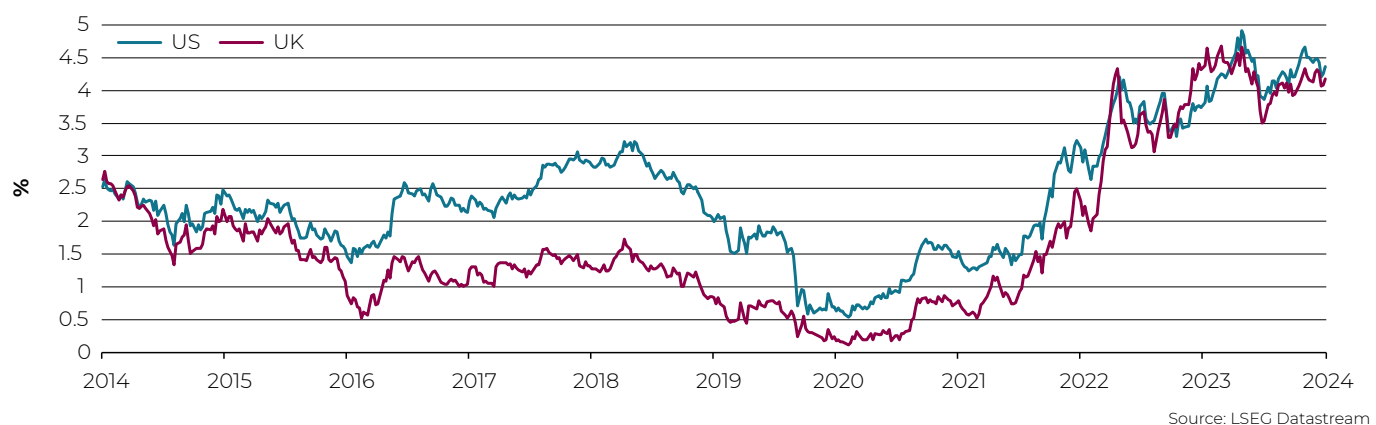
CHART 2: REAL TRADE-WEIGHTED EXCHANGE RATES



The pound has lost significant ground against the dollar, especially in the post-Brexit years. The real trade-weighted pound is near the bottom end of its historic range, while the dollar is near the top of its own range. A contrarian would argue that sterling is due a cyclical rebound, and vice versa for the greenback. The structural roles of each are unlikely to change soon.

It is often argued that the US benefits from the dollar's reserve currency status and would face much higher borrowing costs if it ever lost its crown. However, the borrowing costs of the current and former incumbents are remarkably similar. The yield on 10-year government bonds, called Treasuries in the US and Gilts in the UK, is slightly above 4% in both cases.

CHART 3: 10-YEAR GOVERNMENT BOND YIELDS IN LOCAL CURRENCY



A potential wild card is government debt, which is elevated in both countries above 100% of GDP and rising rapidly in the American case. Neither Joe Biden nor Donald Trump have made debt a campaign issue in the looming election, and debt levels look set to rise irrespective of who wins since

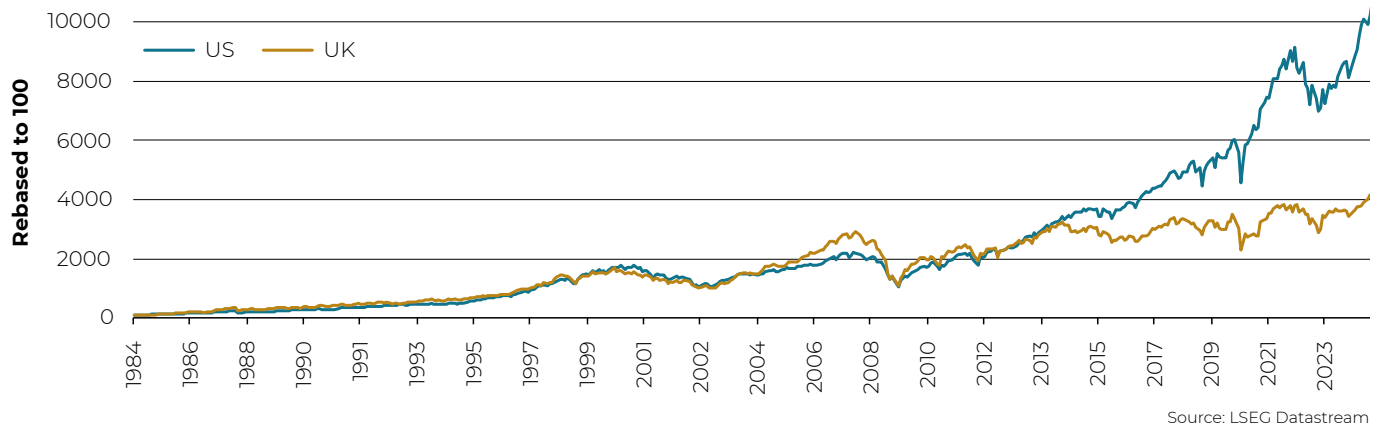
the Republicans favour tax cuts and the Democrats increased government spending. Both countries issue debt in currencies they control, so unlike in the case of Greece a decade ago, default risk is low. However, bond yields can surge higher if markets rebel against continued unsustainable borrowing.

American politicians should take note of Liz Truss' disastrous 2022 mini-Budget, which caused a panic in the bond market and gave her short premiership the death knell.

If bonds have behaved similarly on both sides of the North Atlantic, the divergence in equity performance on both sides of the pond is striking. As chart 3 below shows, US

and UK equities expressed in common currency performed very similarly over the three decades to 2014, but in the decade since, the US has been in league of its own as investors rewarded US shares for superior earnings growth. UK earnings have been flat in dollar terms in the past decade, but US earnings are 80% higher.

CHART 4: US AND UK EQUITIES IN US \$, DIVIDENDS REINVESTED



But this enthusiasm has seemingly gone to extremes, and US large caps now trade at 20 times forward earnings, while the UK market only trades at 11 times. Again, a contrarian would argue that the cheaper market is likely to offer the better long-term returns, though in the short-term, the momentum is certainly with the US.

As with the JSE, there is much handwringing over the lack of new listings on the London Stock Exchange. Exciting UK-based tech startups and even a few LSE-listed stalwarts are considering shifting their listing to New York where their share prices could rerate to American levels.

GREEN GRASS

Finally, what can South African investors learn from the above? It is a reminder that politics is a messy business in most countries, not just our own. Even in very rich countries, large segments of the public are deeply unhappy. The grass clearly isn't always greener on the other side.

Secondly, we've just been through an important election in South Africa, but not all elections move the needle for investments. Last week's UK election could be one noted by future historians, but it will not necessarily have a huge impact on market returns. The US vote in November is probably more consequential, and markets are digesting the higher probability of a Donald Trump win after President Joe Biden's disastrous performance during the first debate emphasised concerns over his age (he is 81, while Trump is not much younger at 77). Love or hate Trump, at least this time round it is less likely to be a surprise to markets if he wins.

Any kind of political analysis should also note how electoral systems work and how power is really exercised. Every electoral system has pros and cons. The Labour Party won a landslide two-thirds of parliamentary seats but only a third of the popular vote. In a constituency system, a minority of the voters can win elections. Nigel Farage's Reform Party won 14% of the vote but only four out of 650 seats. South Africa has a proportional representation system, so even

small parties get into parliament. But it also means extreme outcomes are less likely. In the US, power is distributed between the White House and Congress. If Trump wins the election but Democrats control Congress, his policy agenda will be blunted. The Supreme Court is also powerful. The lifetime appointments Trump made during his term in office will outlast his presidency and continue to shape the law for years to come.

Finally, some South African investors have advocated an offshore-at-all-costs strategy in response to lacklustre local equity returns. Clearly though, not all international investments are the same. A UK-heavy portfolio would probably have beaten a South Africa-heavy one, but not by all that much. Moreover, some of the conditions that gave rise to UK markets lagging the US also apply to South Africa, including outsized commodity exposure. The global environment in which the UK rerates is also one where South African equities should benefit, namely one where "value" shares are back in vogue. There is no guarantee that this will happen any time soon, but there is also no guarantee that the past decade of US outperformance will repeat. This is not because of major underlying weakness in the US – it retains unique strengths, after all. But historically, markets that trade at above average valuations have consistently delivered below-average returns over the decade or so.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 581.0	1.96%	1.96%	13.00%	20.94%
United States	S&P 500	US\$	5 567.0	1.96%	1.96%	16.71%	25.19%
Europe	MSCI Europe	US\$	2 136.0	1.96%	1.96%	5.74%	12.07%
Britain	FTSE 100	US\$	10 513.0	1.83%	1.83%	6.77%	11.19%
Germany	DAX	US\$	1 736.0	2.36%	2.36%	10.77%	13.76%
Japan	Nikkei 225	US\$	254.5	3.43%	3.43%	7.26%	10.45%
Emerging Markets	MSCI Emerging Markets	US\$	1 105.0	1.75%	1.75%	7.91%	10.39%
Brazil	MSCI Brazil	US\$	1 446.0	2.70%	2.70%	-19.67%	-11.99%
China	MSCI China	US\$	57.8	0.71%	0.71%	4.20%	-4.71%
India	MSCI India	US\$	1 091.4	1.71%	1.71%	18.37%	34.57%
South Africa	MSCI South Africa	US\$	433.0	1.41%	1.41%	4.34%	10.18%

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	80 797.0	1.37%	1.37%	5.08%	6.44%
All Share	All Share (Total Return)	Rand	14 532.0	1.40%	1.40%	7.23%	10.82%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	35 604.7	1.49%	1.49%	7.30%	11.92%
TOP 40/Large Caps	Top 40	Rand	13 123.0	1.05%	1.05%	6.60%	8.53%
Mid Caps	Mid Cap	Rand	23 450.0	1.87%	1.87%	7.64%	19.07%
Small Companies	Small Cap	Rand	37 301.0	4.24%	4.24%	14.21%	25.41%
Resources	Resource 20	Rand	5 318.3	4.89%	4.89%	9.39%	2.73%
Industrials	Industrial 25	Rand	23 434.0	-0.18%	-0.18%	5.54%	5.50%
Financials	Financial 15	Rand	14 103.0	0.41%	0.41%	9.23%	24.18%
Listed Property	SA Listed Property	Rand	2 089.2	2.32%	2.31%	12.08%	28.17%

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\$	74.2	0.59%	0.59%	-5.36%	-2.88%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 010.1	1.76%	1.76%	7.41%	15.70%
Government Bonds	BESA GOVI	Rand	995.0	1.75%	1.75%	7.34%	15.62%
Inflation Linked Bonds	BESA CILI	Rand	357.6	0.35%	0.35%	2.39%	9.08%
Cash	STEFI Composite	Rand	571.8	0.16%	0.16%	4.33%	8.55%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	86.5	1.81%	1.81%	12.39%	12.39%
Gold	Gold Spot	US\$	2 391.0	2.79%	2.79%	15.90%	24.01%
Platinum	Platinum Spot	US\$	1 030.0	3.62%	3.62%	4.36%	12.57%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.18	0.07%	0.07%	0.67%	3.37%
ZAR/Pound	ZAR/GBP	Rand	23.29	-1.20%	-1.20%	0.04%	2.53%
ZAR/Euro	ZAR/EUR	Rand	19.70	-1.00%	-1.00%	2.55%	3.57%
Dollar/Euro	USD/EUR	US\$	1.08	-0.93%	-0.83%	2.22%	0.93%
Dollar/Pound	USD/GBP	US\$	1.28	-1.32%	-1.68%	-0.90%	-0.90%
Dollar/Yen	USD/JPY	US\$	0.01	-0.06%	-0.06%	13.98%	11.11%

Source: I-Net, figures as at 5 July 2024

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.



WEALTH

Old Mutual Wealth is brought to you through several authorised Financial Services Providers in the Old Mutual Group who make up the elite service offering. This document is for information purposes only and does not constitute financial advice in any way or form. It is important to consult a financial planner to receive financial advice before acting on any information contained herein. Old Mutual Wealth and its directors, officers and employees shall not be responsible and disclaims all liability for any loss, damage (whether direct, indirect, special or consequential) and/or expense of any nature whatsoever, which may be suffered as a result of or which may be attributable, directly or indirectly, to the use of, or reliance upon any information contained in this document.