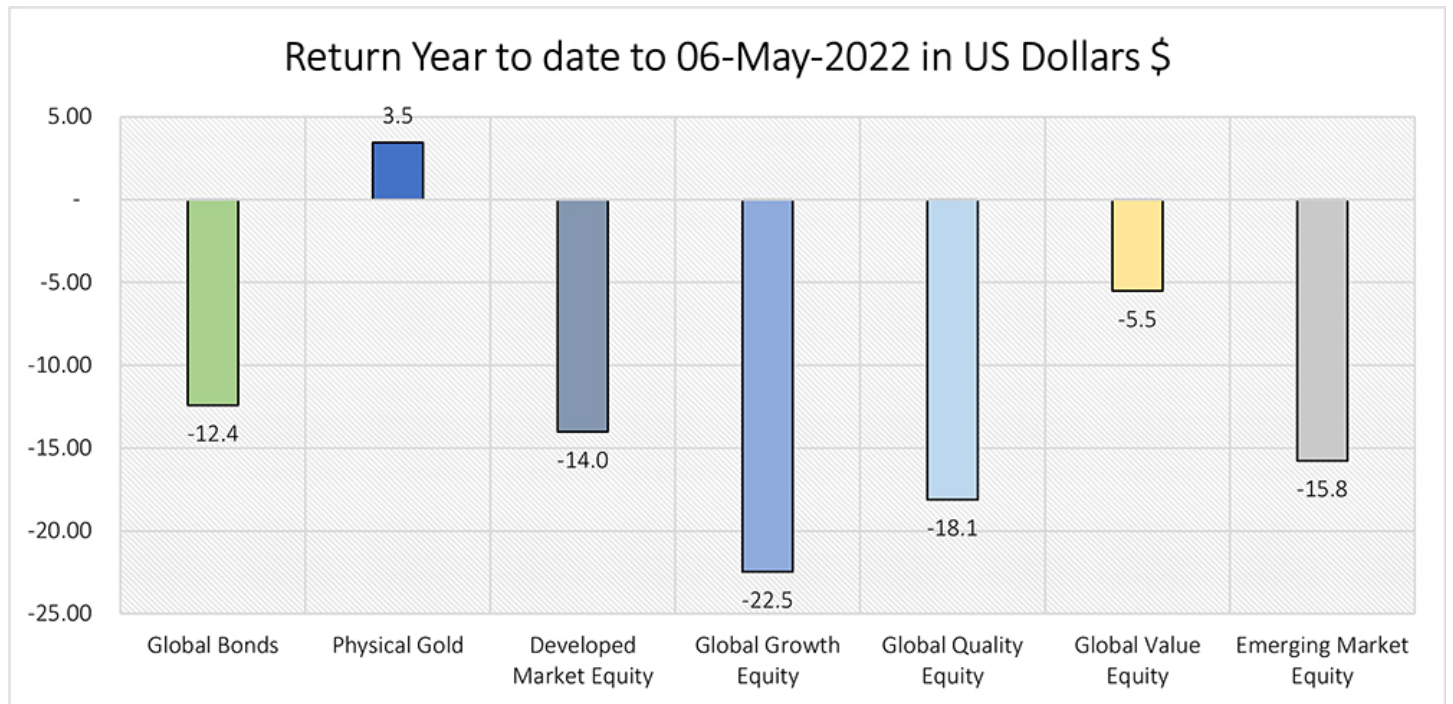




The Great Rotation?

In the aftermath of the Global Financial Crisis, and the easy monetary policy and stimulus which followed, it has been a relentless surge upwards in investment markets, momentarily paused only by the COVID pandemic in 2020. As at the end of 2021, the average 10-year return for an investor in the S&P 500 was 15.8% per year in US dollars. A full 14% above inflation, per year, for a decade!

While the current pullback is unwelcome, and can cause anxiety and stress for investors, at least it is coming off a lofty perch where wealth levels have been elevated for some time.



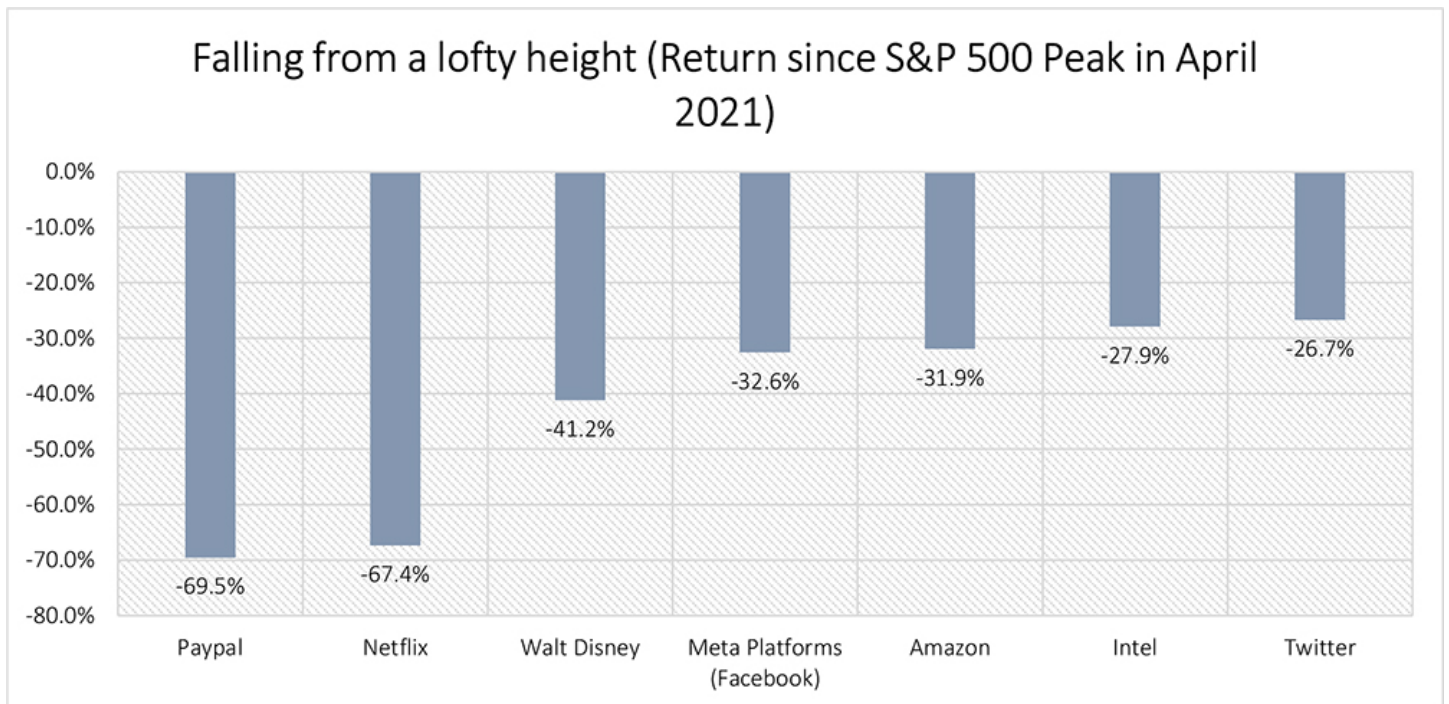
Source: Fundhouse/FE Analytics

The Russian conflict has had a role to play in this current market correction, and the tighter regulation in China has also served to deflate some of the high fliers (notably our own Naspers/Tencent), however it has been the slow, grinding, behind the scenes build up of inflation which has ultimately proven that it is a) notoriously difficult to predict and b) is the great humbler for the most optimistic of investors.

Inflation can be somewhat of an opaque and distant feature of investing. While it sits at the heart of most investment objectives, in itself it is one of those items which investors prefer to leave for later, something to talk about but not to get too close to. So, when it rears its head, it tends to surprise. Moreover, we have not seen proper global inflation for a number of decades, and very few fund managers today have managed money through a high inflationary environment.

At a base level, inflation raises the cost of money, tends to make financial assets worth less, and narrows the creation of wealth.

As the news that high inflation – 8% per year and counting – was the new normal in the US at the start of the year, markets reacted quite violently, with past beneficiaries of low inflation feeling the brunt. This includes the likes of Paypal, Netflix, Amazon and Disney – household names riding high on the ‘fourth industrial revolution’[1]:



Source: Fundhouse/Refinitiv

So why have these household names taken most of the brunt? In a world with low inflation and high economic activity (profitability, growth, low unemployment etc), there has been little need to hike interest rates which would usually cool off an overheating economy.

To muddy the waters, the trend towards globalisation (increasing scale benefits) as well as technological innovation (a dampener on manufacturing and productivity costs) has meant that inflation has been somewhat of a forgotten child. In this world, interest rates remain low, and this supports businesses which are growing new business models, attracting new clients, spending significant sums on research and development, as well as acquisitions on complementary businesses. A world awash with cheap money is both fun to play in, and self-fulfilling as growth creates growth.

While the cheap money does ultimately create the favourable conditions to roll out new business models such as Twitter or Facebook, it also gets investors really excited, to the extent they are drawn into the endless cycle of growth. The party is on, and companies grow to the sky. Unfortunately, for every successful company there is still a price which is reasonable to pay for its prospects, and this can get neglected in markets which are frothy, as they have been. So when inflation comes to town, and with it the prospect of higher interest rates, lower economic activity and a general reduction in optimism levels, the high fliers get the biggest hit, as they have done of late. Practically what this means is that your 10-year return since 2012, which was 15.8% per year, is now a 'mere' 13.7% per year. Despite the current pullback long term investors still have much to be pleased about.

While many are focussed on the losers right now, there are numerous winners where investors have started the great rotation back into cheaper value shares, the unpopular view of the past decade.

While this scenario playing out is straightforward to give running commentary on, the important question to ask is what have we, or any other investment provider, done about it? Have we been prepared?

Hopefully, yes. One of the spoils we enjoy from our fund research work is we get indepth exposure to a wide swathe of fund managers around the globe who each see the world differently. They are all focussed on their ideal opportunities, and these tend to go through peaks and troughs, and we follow them, observe them, and question them on this journey.



This testing of ideas and views is what has led us to an investment outlook which accommodates the inflationary impact taking place today. For some time, we have advised clients to maintain a few critical elements in their investment portfolios. For instance:

- Global high-quality equities are great companies, but have been significant beneficiaries of low inflation and as such should be held in a minority position as they are relatively expensive (good companies can be poor investments). This would include Ninety One, Fundsmith, Lindsell Train and BNY in the table below. As you can see they have lagged in this sell-off – counterintuitive for companies which are supposedly defensive, but not when viewed through the lens of inflation returning.
- Global growth companies, such as those invested in by Baillie Gifford, do offer genuine new opportunities, but they have been chased up in price by everyone from the day trader to the me-too investor. Again – great opportunities, but prices have not discounted inflation returning, so hold a minority position and time your additions well, ideally into substantial weakness.
- Hold significant exposure to so-called ‘value’ shares. These are the more typical, mature cyclical companies which are less exciting, but generally quite robust and for various reasons are trading too cheaply. The likes of banks (make no money when rates are low), oil (dirty smelly oil), healthcare (COVID impacted bed traffic) and a wider range of forgotten industrial companies can provide some decent inflation protection just when it matters most. For this we have typically advised clients to hold the majority of their equity allocation.
- Definitely avoid any form of global bond exposure in developed markets. A sure fire way to lose money. (global bonds have lost 15% of their value so far, which you are unlikely to get back). So much for the risk free asset.

The table below covers a sample of funds we follow. The Value funds have been recent winners as inflation has surprised, and Growth and Quality shares have taken most of the brunt so far. Emerging Markets are weak as the China regulatory hangover persists, and a fresh bout of COVID lockdowns impedes their economic growth.

Fund	Investment Approach	Return YTD
Dodge and Cox Global Stock	Value/Contrarian	-4.8
Schroder Global Recovery	Value/Contrarian	-8.0
Artisan Global Value	Value/Contrarian	-9.4
Orbis Global Equity	Value/Contrarian	-12.2
Nedgroup Global Equity	Quality	-13.0
MSCI ACWI	Market Index	-14.2
Fidelity World	Market Index	-15.1
Lindsell Train Global Equity	Quality	-15.4
Ninety One Global Franchise	Quality	-18.1
BNY Mellon Long Term	Quality	-18.6
Fundsmith Equity	Quality-Growth	-22.0
Fidelity Emerging Markets	Emerging Markets	-28.2
Baillie Gifford Worldwide Discovery	Growth	-34.9
Baillie Gifford Worldwide Long Term Global Growth	Growth	-40.0

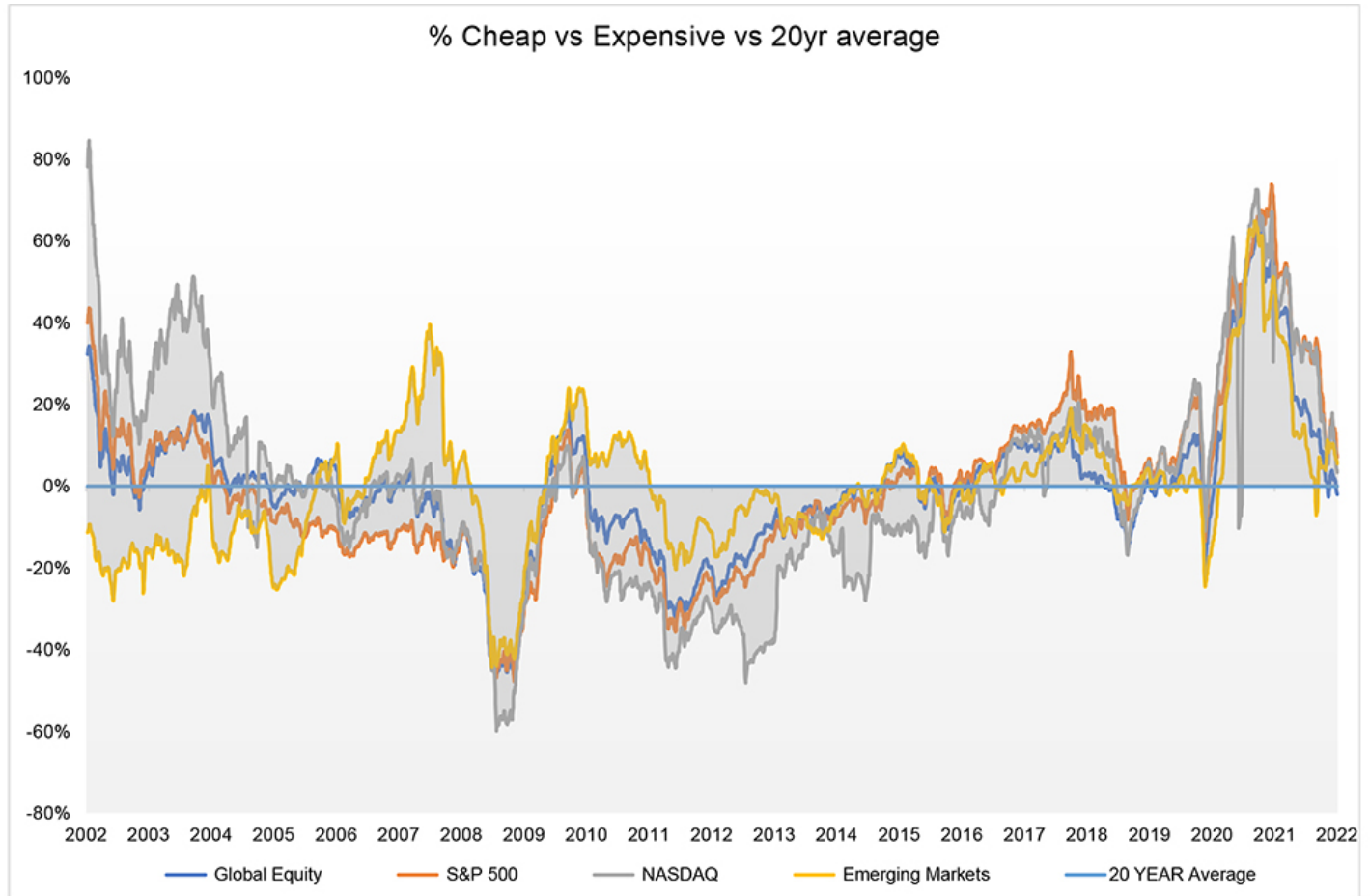
Source: Fundhouse/FE Analytics

This form of balanced approach allows for a measured uptake of a range of investment opportunities, without being too clever and without buying after the fact, when returns have come and gone.

So, where does this leave us today? We are assessing a number of potential decisions on behalf of clients. For instance, has the market overreacted? What is already priced in? Are equities cheap or expensive? Should we be buying up some global bonds for the first time in forever?



The chart below pulls together a sense check quite nicely. Irrespective of differences between markets, or what has done well or not of late, over a two-decade horizon we can test current market levels against longer term averages. What it tells you is that by and large the main global equity markets have reverted back to the long term average (read differently: excessive market valuations have been deflated!). Looking forward though, investors should be more optimistic about prospects which lie ahead, from this point. As the various markets correct, it also provides us with opportunities to further diversify client portfolios.



Source: Fundhouse/Refinitiv

At points like this it is tempting to conclude that inflation will wipe out our hard-earned wealth. In fact, in the majority of scenarios inflation can actually be positive for global growth and equity markets, provided that any tempering of inflation is done evenly - the so called 'soft-landing' touted by the US Fed.

For lower risk 'balanced' or 'cautious' investors, this fall in bond prices and rise in interest rates is good news! It has been virtually impossible to adequately diversify a portfolio away from equities when the assets that do the heavy lifting in mitigating risk have been poor options. Looking ahead, these look to be coming back into play.

Lastly, this is all healthy! Much like going on diet, a broad normalisation of equity and bond markets provides a broader opportunity set in future (ie better diversification for investors, and more opportunities).



We believe one of the most important positive health consequences of this change is that the global monetary system gets to reset, by raising interest rates and hopefully preserving economic activity. This puts us on a path to normal interest rates, which provides the critical shock absorber which will be much needed in the next crisis – thereby protecting future wealth. To date the global economy has been dangerously exposed to a further crisis at a point where debt levels are too high and record low interest rate levels provide no room to support an economy in need.

We don't know where or how the inflation story ends. We can only observe the price you pay today for the investment opportunity you get. At current price levels, there are an increasingly varied and interesting set of opportunities putting themselves into position for the next decade of wealth creation.

The Great Rotation? Unlikely. We don't see a narrow universe of options in future and a structural aversion to beneficiaries of the low interest rate environment in the past, but rather a significantly wider array of better priced investment options. This is great for maximising returns for clients and for portfolio management in general.

[1] This refers to the prevalence of the 'internet of things' as the driver of economic growth through technology



MARKET REPORT

30/04/2022

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.8%	0.0%	13.2%	11.3%	9.8%	11.2%	15.5%	13.2%
FTSE/JSE SA Listed Property	ZAR	0.2%	-2.7%	12.2%	-5.3%	-5.2%	4.6%	26.3%	21.3%
SA All Bond Index (ALBI)	ZAR	-0.7%	0.1%	8.4%	7.5%	8.2%	7.8%	8.1%	7.9%
SA Cash Index (SteFI)	ZAR	1.0%	1.4%	4.0%	5.1%	6.0%	6.1%	0.4%	0.4%
Balanced Benchmark	ZAR	-1.8%	-2.7%	9.5%	9.7%	9.1%	11.0%	10.6%	8.8%
SA Inflation (1 month lag)	ZAR	1.8%	2.4%	5.9%	4.7%	4.3%	5.0%	1.3%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	-8.0%	-12.9%	-3.1%	11.0%	10.7%	10.6%	15.9%	13.6%
Emerging Markets Equity (Datastream EM)	USD	-10.4%	-12.1%	-18.1%	2.6%	4.7%	3.3%	16.8%	16.0%
Global Property	USD	-2.6%	-9.5%	3.7%	6.7%	7.5%	7.9%	15.5%	14.2%
Global Bonds (Barclays Global Bond Index)	USD	-11.7%	-13.9%	-15.5%	-1.4%	0.4%	0.4%	6.3%	6.1%
Global Cash	USD	0.2%	0.2%	0.3%	0.8%	1.3%	0.9%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.8%	0.0%	13.2%	11.3%	9.8%	11.2%	15.5%	13.2%
Global Equity (Datastream World)	ZAR	-6.0%	-13.7%	5.6%	14.6%	14.5%	18.8%	16.2%	14.8%
Emerging Markets Equity (Datastream EM)	ZAR	-8.4%	-12.9%	-10.7%	6.0%	8.2%	10.9%	14.2%	13.1%
Global Property	ZAR	-0.4%	-10.3%	13.1%	10.3%	11.2%	15.9%	17.0%	14.9%
SA All Bond Index (ALBI)	ZAR	-0.7%	0.1%	8.4%	7.5%	8.2%	7.8%	8.1%	7.9%
Global Bonds (Barclays Global Bond Index)	ZAR	-9.7%	-14.7%	-7.9%	1.9%	3.8%	7.9%	15.6%	14.0%
COMMODITIES									
Gold (US Dollars)	USD	6.2%	4.7%	7.8%	14.2%	8.5%	1.4%	12.6%	14.6%
Gold (Rands)	ZAR	8.6%	3.8%	17.5%	18.0%	12.2%	8.9%		
CURRENCIES									
Rand / Dollar	ZAR	-2.2%	0.9%	-9.0%	-3.3%	-3.4%	-7.4%	16.0%	15.2%
Rand / GBP Pound	ZAR	4.3%	8.1%	1.1%	-2.0%	-2.8%	-4.7%	14.8%	14.6%
Rand / Euro	ZAR	3.8%	8.1%	4.5%	-1.3%	-2.7%	-5.0%	14.3%	13.7%
Spot Rates									
		29-Apr-22	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago		
CURRENCIES									
Rand/US\$	Rand	15.82	14.61	14.51	13.38	7.75	10.63		
Rand/GBP	Rand	19.85	19.23	19.94	17.32	12.59	15.50		
Rand/EUR	Rand	16.69	16.26	17.46	14.57	10.26	9.58		
RATES									
Libor 6m \$	US\$	1.91	1.47	0.20	1.43	0.73	2.12		
Repo Rate	Rand	4.25	4.25	3.50	7.00	5.50	11.50		
Prime	Rand	7.75	7.75	7.00	10.50	9.00	14.00		
All Bond Index Yield	Rand	10.45	10.08	11.64	9.28	7.89	9.74		
COMMODITIES									
Gold (\$/oz)	US\$	1908.49	1941.15	1770.46	1267.86	1660.28	307.70		
Platinum	US\$	932.00	983.00	1218.00	946.00	1570.00	536.00		
Oil (Brent Crude) \$	US\$	107.83	107.46	67.36	51.56	119.29	26.45		
INFLATION									
SA Inflation	%	5.9	5.9	4.4	5.2	5.9	9.4		

Fundhouse is a leading investment adviser specialising in fund research, ratings and portfolio construction services. We help clients manage investments on behalf of the end investor. Our experienced team understands the complexities of the fund management world. We apply this knowledge alongside a client first mindset to improve the outcome for the end investor.

Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.

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