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Investing for a
world of change

Navigating volatility – highlights from our webinar

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Over the last few weeks, investors have had to contend with sharp market swings which have wiped out months of capital growth. Key factors that have weighed on markets include worries about global inflation, the Russia-Ukraine war, and Chinese growth and lockdowns. Understandably, market volatility and plummeting asset prices have sparked concern among investors.

Ninety One's Co-Head of Quality, Clyde Rossouw, and Peter Kent, Co-Head of SA and Africa Fixed Income, shared their insights in our recent webinar. Here is an edited summary of their market views and how they are capturing opportunities and managing market risk.

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Q Central banks have been raising interest rates to fight inflation, and financial markets have been under severe pressure. Does inflation have to roll over for markets to settle?

Peter Kent (PK): Markets need to see inflation coming down. It is clearly above where central banks want it to be. Supply chains have been affected by COVID and more recently, the Russia-Ukraine situation has resulted in disruptions. So a lot of the inflation we are seeing reflects goods not getting to people. The other side of the equation is demand. Consumers across the developed world are in a strong financial position, so demand has surged while there have been supply challenges. This has fuelled inflation.

Ongoing supply disruptions mean that the US Federal Reserve (the Fed) is focusing its efforts to cool down the demand side of the economy. The Fed is fighting inflation by raising its federal funds rate and letting its bond holdings mature over time.

> Tighter financial conditions should help to cool the global economy down and tame high inflation.

Bond markets have led the charge to cool the global economy down. Yields have been rising in response to higher inflation (yields go up when bond prices fall). However, recently we've seen financial conditions tighten on a broader front as other asset markets (the dollar, equities and credit) have started 'sharing the load' of dampening demand. For example, a stronger dollar has helped to slow down exports while the plunge in equity prices should translate into lower US consumer spending. (When asset prices decline, households tend to spend less due to the impact on their pension funds and other investments.) Tighter financial conditions should help to cool the global economy down and tame high inflation. Bond markets seem more settled, with the US Federal funds rate expected to peak at around 3.15% next year. This is the first bit of good news in ages for bond investors.

However, it is not the kind of environment where you want to pile into global bonds. The inflation outlook is still concerning. But now that we're seeing tighter financial conditions across asset classes, we have gradually started to gain exposure to shorter-dated US bonds in the Ninety One Diversified Income Fund, as a defensive play.

Q We have seen a shift from abundance to scarcity due to tighter financial conditions and supply chain disruptions. This has benefited some sectors such as commodities and weighed on others such as technology. What should investors make of this?

Clyde Rossouw (CR): Commodities have been an obvious place for investors to hide: they have focused on the supply disruption story but ignored changes in demand. Before piling into commodity stocks because they look cheap, investors should carefully consider what is happening on the demand side. As a leading consumer of commodities, China is a key determinant of future demand. However, China's growth prospects have deteriorated, which means the demand dynamics could change substantially for commodities going forward.

How is it possible that the market can get so carried away and tar everything with the same brush?

The real issue that investors should grapple with is whether global growth will fall short of expectations. If bond yields are set to peak at around 3%, then growth forecasts may be revised lower. Before equity investors become too alarmed, please bear in mind that, to a large extent, the growth shortfall is already embedded in stock prices. If you look across the board – whether you consider Chinese technology stocks or US technology stocks – share prices are down between 60% and 90%. How is it possible that the market can get so carried away and tar everything with the same brush?

While it has been a difficult time for investors, as investment managers, we are excited about the opportunities that we see on the horizon.

Of course, not all stocks will see a rebound, such as profitless tech, but it's important to consider the upside potential of those businesses that are actually profitable. We see businesses that are able to continue growing in this tough environment as a scarce commodity: they are going to become very valuable in the marketplace in the next 3-12 months. So while it has been a difficult time for investors, as investment managers, we are excited about the opportunities that we see on the horizon.

Q You recently remarked: "There is still no quality in value but there is value in quality." What is the outlook for the quality style of investing – how do you go about investing in this tough environment?

CR: What's really important for investors to take away is that quality is not a one-trick pony. Within the quality ambit, we can invest in structural growth businesses. These are companies that may not have the cheapest market valuations, but they will provide investors with steady, consistent growth for 5-10 years because of their structurally-advantaged business models.

We also find quality businesses with cyclical characteristics. Healthcare stocks, which have defensive characteristics, are another important tool in our arsenal. We have a material exposure to healthcare stocks in the Ninety One Global Franchise Fund. These stocks typically don't perform as strongly as technology in a normal market environment, but they do their job when conditions are tough.

We have a diverse allocation to quality stocks, which gives us scope to tilt the portfolio towards stocks and sectors that will provide attractive long-term returns. For example, Beiersdorf owns a collection of strong beauty and personal care brands across the full spectrum of price points: mass (NIVEA), derma (Eucerin/Aquaphor), super premium (La Prairie) and healthcare (Elastoplast). In contrast, Intuit controls near monopolies in the US within small business accounting software (QuickBooks) and online tax filings (TurboTax). These offerings ease the burden of manual, labour-intensive and costly services. They allow customers to perform tasks themselves with software, dramatically reducing costs. Both stocks offer distinct and enticing entry points into differentiated sectors.

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Importantly, the stocks in our Ninety One Global Franchise portfolio trade on a 4% free cash-flow yield, which is ahead of the market. Free cash-flow yield is an important indicator of how capable a company is to make good on all of its obligations. In essence, it is a solid pointer of how financially stable a company is. Our holdings also offer protection from prolonged inflationary pressures: they have significant pricing power given their strong competitive positions; they are low capital intensity businesses, backed by intangible assets; and they have healthy balance sheets, insulating them from rising financing costs.

In a world where liquidity is scarce, it's key to consider businesses' ability to generate cash flows and profits and whether companies need access to capital, which is becoming far more expensive. These are the investment ideas on which we focus our attention.

Q South African bonds have also been facing the headwinds of higher inflation and rising interest rates. Are they still attractive as an investment?

PK: We all tend to get a bit downbeat on South Africa, but the internal resilience of our country really came to the fore if you think of COVID and what's happening in Ukraine. Our national savings pool was able to fund the deficits we were forced to run because of COVID, and if you look at the Russia-Ukraine situation, our terms of trade actually improved, thanks to our commodity exports. The rand has been fairly well behaved compared to other emerging market currencies, and SA bonds have actually outperformed.

The investment case for SA bonds is just leagues ahead of most other emerging markets. Our politics can be noisy and scary, but the direction on that front is marginally positive, as is our fiscal trajectory. S&P Global revised the outlook on South Africa's sovereign credit rating from stable to positive in May, citing the country's favourable terms of trade as supportive for government finances.

While the SA inflation picture is deteriorating with the rest of the world, the Reserve Bank has been moving pre-emptively and is on top of the situation. At a yield above 10%, our 10-year government bonds make for a very compelling investment case. Of course, SA bonds are not riskless, but the yield compensates investors for some of the risk. Investors in 10-year SA government bonds are still earning a very attractive real yield, whereas 10-year US Treasuries remain low in comparison, with deeply negative real yields.

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Given high real yields, we believe that SA bonds continue to offer an appealing long-term income opportunity for investors. Our bond position in the Ninety One Diversified Income Fund hasn't moved materially over the last couple of years. We combine a core bond position with a dynamic hedging strategy that provides some protection against local and global risks.

Given the moves in the dollar, the rand looks more vulnerable than it has been over the last year or so.

In terms of our offshore exposure, we didn't use the maximum that Regulation 28 allowed us previously. So the fact that the offshore limit has increased, will not impact our current asset allocation. We don't believe SA bonds are under significant pressure from capital being exported offshore due to the Regulation 28 changes. However, given the moves in the dollar, the rand looks more vulnerable than it has been over the last year or so. Hence, we are going to be using our offshore allocation (foreign exchange exposure) to mitigate the risk of local currency weakness.

Q From an SA multi-asset perspective, what is the outlook for the various asset classes on a five-year view?

We expect the global equity holdings to be the top-performing asset class, providing annualised returns of more than 10% per year on average (in rand terms).

CR: Given the sharp market sell-off, we see many compelling opportunities, particularly in global equities, but SA equities also look attractive. Over the next five years, we expect the global equity holdings in our Ninety One Opportunity Fund and Ninety One Cautious Managed Fund to be the top-performing asset class, providing annualised returns of more than 10% per year on average (in rand terms). Our SA equity holdings should also generate strong returns over this period.

SA bonds remain an important component in our portfolios, providing a steady, inflation-beating income to investors. While we understand the fiscal constraints in South Africa and the risk that could pose to domestic bonds, investors are being offered a reasonable yield, pocketing close to 10%. Looking towards the next five years, we expect the SA equity holdings in our portfolio to outperform SA bonds. While market conditions are currently difficult, we remain focused on building portfolios of high-quality assets that will provide attractive returns over the long term.

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Viewpoints