December 2022

Establishing Order in a Disorderly World

Richard Harris I December 2022

As we near the end of 2023, it is important to take a step back and reflect on what has been another action-packed year, albeit somewhat different to the trials and tribulations that 2020 and 2021 brought us. The Omicron variant that crept in at the end of last year was unfortunately not the last of our COVID-related woes, and 2022 proved to be the year where many of the policies and aid implemented during the pandemic were unwound.

From the get-go this year, markets started to drift lower as investors became aware of the effects of extreme inflation and began pricing in aggressive rate hikes from Central Banks as a response. This narrative was catalysed in March when Russia took action against Ukraine and NATO by declaring war, adding further supply-side inflation to the equation, predominantly via energy and food prices.

Global volatility took off across markets and industries as investors tried their best to navigate this new regime of higher interest rates and escalating geopolitics. Companies, industries, and consumers exposed to large amounts of debt were affected the most. We saw longer-duration tech companies and speculative asset classes lose as much as 80% of their value over the same period and an obvious movement of flows to defensive companies and industries as a result, with the US Dollar (a safe-haven asset) strengthening almost 20% against its global peers.

The political madness that followed this global volatility was remarkable as bureaucrats scrambled to find common ground between aiding their populations, remaining in power, and sanctioning countries and industries that did not conform to their ideologies, whether right or wrong.

Despite this disorder, if we look at the returns of many indexes now in December, it is difficult to comprehend that all the above occurred. Major indexes such as the S&P 500 and the Dow Jones Industrial Average are down a meager 14% and 5% respectively, with the UK's FTSE 100 and JSE Allshare slightly positive at the time of writing this note.

From an investment standpoint, most are breathing a sigh of relief with global inflation showing signs of topping (for now), signalling that Central Banks will at least start slowing the pace of hikes in their upcoming meetings. Many investors are building optimism and expecting a V-shape recovery in global markets, as we have witnessed during extreme drawdowns the last decade.

The key issues with this thought process, however, are:

(1) Central Banks are still hiking rates and even when they eventually stop, are likely to hold rates elevated until inflation is reduced by directly targeting consumer demand.

(2) There is a lagged effect between the implementation of rate hikes and the actual effect that these hikes have on the economy, consumers, and businesses (as illustrated in our October 2022 Newsletter Chart of the Month).

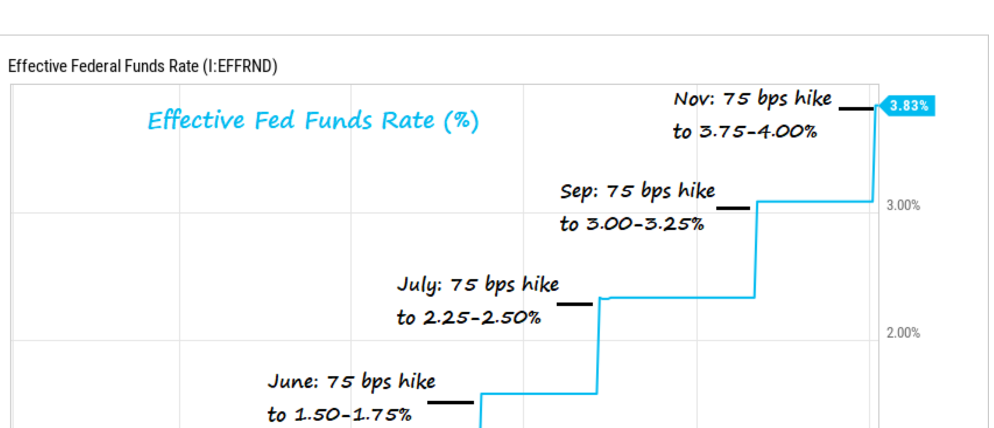
As of writing, although the Federal Reserve has signalled its intent to slow the pace of these rate hikes, Federal Reserve Chair, Jerome Powell, has been very clear on his commentary to slow inflation. The market is still pricing in one more rate hike of 0.5% that should take the Fed Funds Rate to 5%, which we believe will be close to the peak and occur in Q1 2023.

The developed world has become accustomed to cheap and easily available credit in the past decade, which has allowed asset prices such as housing and certain stocks to explode as a result. Interest payments on this debt have increased over the last year and cut into the disposable income of many. Those with mounting debt and interest payments have thus had to start restricting other, more discretionary areas of their lifestyles in order to afford these elevated payments.

As this cycle plays out and interest rates stay higher for longer, those with large debt burdens may need to sell these expensive assets to afford general living expenses, leading to pressure on large markets such as vehicles, housing, and companies, that produce and sell non-essential goods.

The outcome is tough to predict accurately. However, it is likely that concerns are to shift from inflation in 2022 to global growth in 2023 as the consumer in general deals with these lagged effects of extreme monetary tightening.

The chart below illustrates the effective Fed Funds Rate in the US. It rose from 0.25% in January 2022 to 4.5% in December (an increase of 18x in the space of a year with another 0.5% increase still to come).



As discussed in previous newsletters, markets are forward pricing and as history has shown, should turn higher before the end of a global recession. It is likely to be a rocky road until we can once again find normality after flushing excess risk from the system.

Below are a few scenarios we are keeping an eye on that should provide better clarity on the global recovery from here forward.

Positive Catalysts

- A softer landing globally - economies show resilience and are affected less by the impacts of recent monetary tightening
- Inflation declines rapidly to the Federal Reserve's acceptable mandated level of 2%
- Greater global collaboration allows for supply chains to open and international trade to flow with ease

Negative Catalysts

- Inflation remains sticky and elevated above 3-4% for longer
- Continued geopolitical tensions, leading to further de-globalisation
- Corporate earnings start to deteriorate as disposable income of the consumer declines
- The interest rate hikes implemented in 2022 have a more pronounced effect on global growth with employment figures and major asset prices plummeting as a result

Although current market conditions are uncomfortable, opportunities are created through uncertainty and despite a fairly negative backdrop, active asset management is likely going to play a larger role than ever in the coming few years.

2022 in South Africa

You don't need to look too far to find a South African with all the signs of stress written into their expression. It has been a trying year for us too at the southern tip of the globe where corruption, loadshedding, infrastructure fails, and lack of leadership highlight our concerns.

We are at a very decisive period in our beloved country where certain factions of the party in power are doing everything to return the country to Zuma-esque anarchy where those in charge have free access to the cookie jar.

Earlier this month, we saw the effects of a possible Ramaphosa exit on the Rand and local businesses listed on the JSE, with SA Inc. losing ~10% of their value in a single day. These share prices and the Rand have since rebounded but from a foreign investment standpoint, seriously jeopardises our already-tarnished name as an investible economy.

Having said that, our local market and many of its constituents are trading at valuations that have not been seen in decades. Despite the current negative economic and political backdrop, many of our local companies are the best in the world and, much like South Africans, are resilient to many difficulties thrown their way. Sectors including Basic Materials and Financials are trading on sub-10 P/E ratios and paying 5-10% of their annual earnings to shareholders through dividends on an annual basis.

There is an abundance of potential for investment in South Africa and all we need is a catalyst to unlock this. This catalyst, however, will need to occur sooner rather than later to allow the right people to step into power and steer the ship in the right direction. We are watching the ANC's National Conference closely (16-20 December) and believe that this nomination is likely to pave the way for local stability or lack thereof leading up to the 2024 general elections.

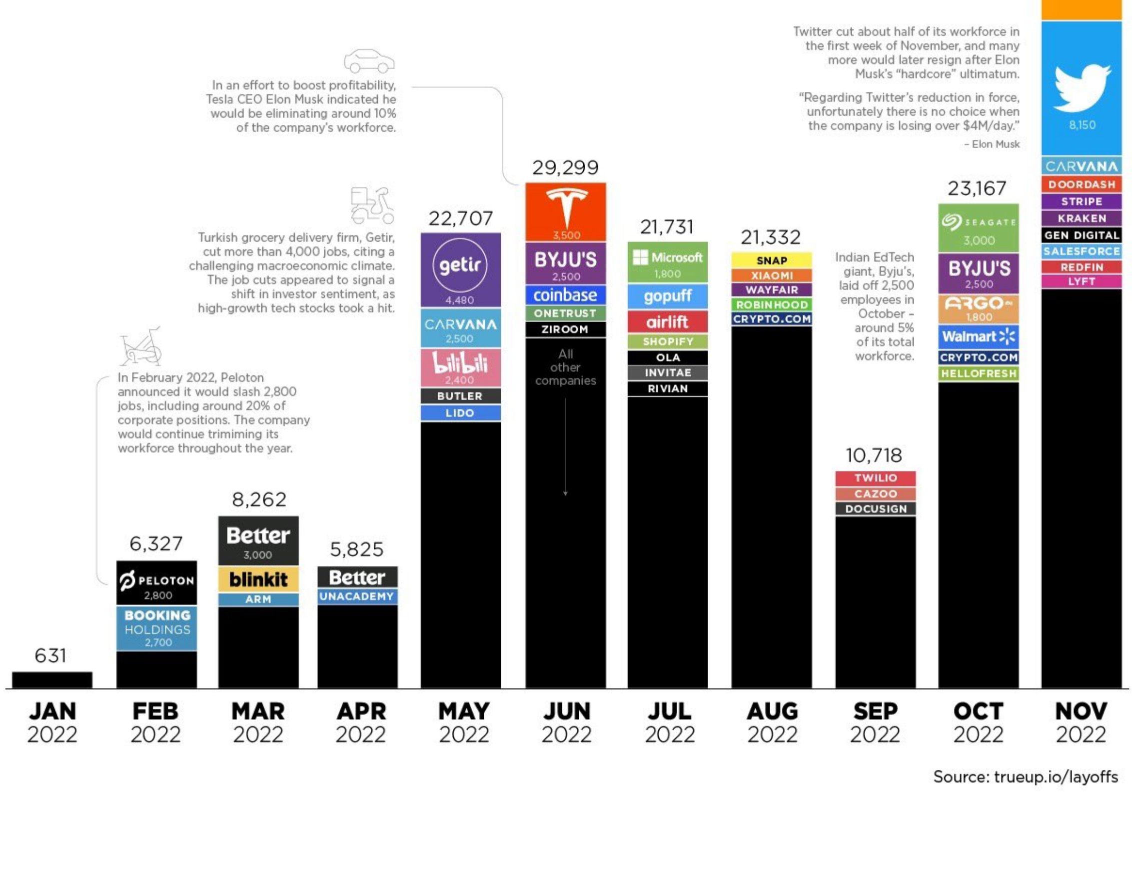
THANK YOU & SEASONS GREETINGS

What a year it has been and from year-end discussions with most, a deserved break is something most are in search of. Although the road ahead may remain somewhat uncertain, be rest assured that we at Absolut Wealth continuously strive to remain one step ahead and will continue to be a shepherd to your investments in the years to come.

We'd like to thank you for your continued support over the past year and wish you and your loved ones a safe and joyous time over the festive season. We look forward to a prosperous 2023!

Chart of the month:

Over the course of 2022, many US Tech companies have alluded to job layoffs as concerns mount over economic conditions and consumer demand in 2023. From the chart below, it is clear that corporate concern is increasing and often company commentary and decision-making are leading indicators for economic activity to come.



"With a good perspective on history, we can have a better understanding of the past and present, and thus a clear vision of the future" - Carlos Slim Helu