momentum investments

Herman van Papendorp
Head of Investment Research & Asset Allocation

in the moment

Sanisha Packirisamy
Economist

Financial market outlook for 2024: Rate reversal rejoice?

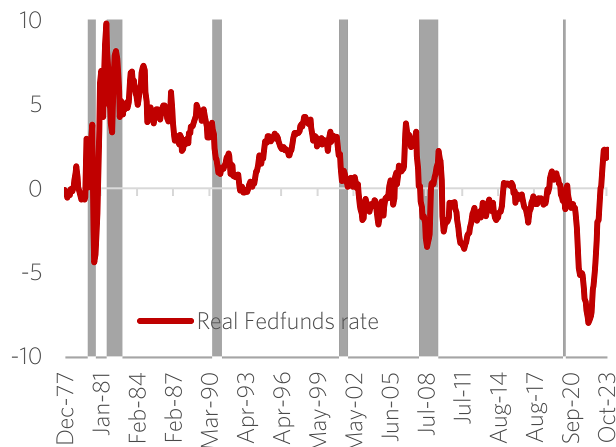
Highlights

- Among the important financial market risks to monitor in 2024 are the likelihood of a United States (US) recession, the outcomes of myriad global elections (including in the US, South Africa (SA) and Taiwan), actual or potential military conflicts around the world, trade friction flare ups and renewed fragilities in China's property sector.
- The narrow-based advancement in the US equity market in 2023 prompts concerns about the sustainability of the upward trend into next year. Furthermore, uncertainties about geopolitics, US growth, inflation and policy rates are not reflected in low US equity volatility levels, potentially constraining future equity returns.
- Historically, US bonds have had a consistently attractive return profile after the final US rate hike. Furthermore, yields across the maturity spectrum of the US yield curve are now higher than equity yields. This makes US fixed income a broader attractive asset class for investors in 2024, particularly for investors looking to move up the duration scale.
- Indications of slowing US economic activity in 2024, with concomitant expectations at the time for the start of a US easing policy cycle subsequently, would provide some positive support to both the US bond and equity markets. We prefer US bonds to US equities until a falling rate cycle is discounted in 2024.
- We are circumspect about global listed property due to the combined negative overhang of debt costs eventually resetting at higher interest rate levels and tight bank lending standards potentially squeezing funding availability.
- A significant risk premium is embedded in rock-bottom SA equity valuations, with little positive sentiment towards the asset class. There is thus ample scope for a rerating should there be improvement in some of the local impediments over time, or if a global risk-on environment takes hold. SA equities are also very underowned by local and global portfolio managers, which implies that there is no overhang in the asset class, enhancing its rerating potential.
- SA nominal bonds similarly discount lots of bad news. A break-even widening in the second half of 2024 in line with the projected inflation trend should provide more fundamental support for inflation-linked bonds (ILBs) as 2024 unfolds. We anticipate a need to increase SA fixed-income duration during 2024 to counter the rising reinvestment risk of shorter-duration fixed-income assets such as cash as we approach the start of the local rate cutting cycle.
- SA listed property nominal and real dividend yields are among the highest in the world. However, the delayed impact of higher interest rates is already starting to hurt SA listed property companies, with further repricing to higher market rates in the offing as interest rate hedges expire and debt matures in the coming years.
- Geopolitics and related central bank gold buying will likely remain dominant positive drivers for the gold price in the interim.

US bonds preferred to US equities until a falling rate cycle is discounted in 2024

Although the likelihood of a US recession has seemingly diminished in recent months, it remains an important financial market risk to monitor going forward. We have reported before that should a US recession indeed be forthcoming, there could still be significant downside risk for growth assets such as global equities, with US equities never having bottomed throughout history before the onset of a recession. Historically successful US recession indicators such as the New York Federal Reserve's (Fed) one-year recession probability model (which has never given a false signal at its current level), US leading economic indicator momentum (which has never before been this negative without a recession following) and US banks' current very tight lending standards (which has historically been associated with a 90% probability of recession within a year according to Deutsche Bank) all still point to a meaningful probability for US recession.

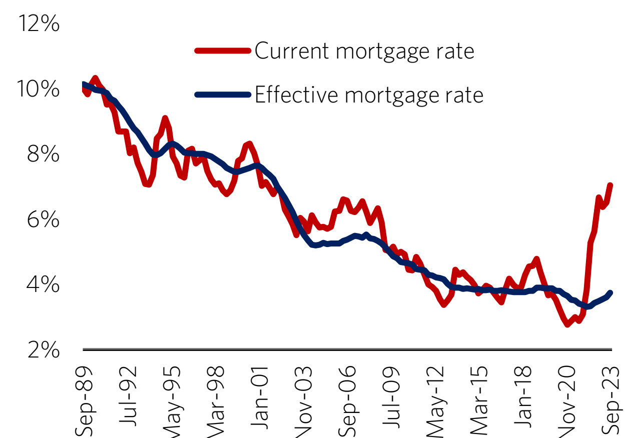
Chart 1: Fed real policy rate only became restrictive recently



Source: Iress, Momentum Investments

The monetary transmission lag between interest rate changes and when these changes are ultimately reflected in the economy is typically long. Research from Deutsche Bank shows that based on the history of the 13 US rising rate cycles in the past 70 years, the period from now until mid-2024 would be the most likely for the start of a US recession. What could be extending the monetary transmission cycle this time is the zero base that US policy rates started from, which caused the US real policy rate to only become restrictive recently from very easy conditions previously (see chart 1). Furthermore, the US consumer is likely less interest rate sensitive than previously. This is due to the 30% that US household balance sheets have delevered since the global financial crisis (GFC), the spending support consumers have enjoyed from solid wage gains, the excess savings built up during the pandemic, as well as the high proportion of US fixed-rate mortgage debt (around 85%) that has contained the effective mortgage cost rise for consumers (see chart 2).

Chart 2: High proportion of US fixed-rate mortgages has contained effective mortgage cost rise

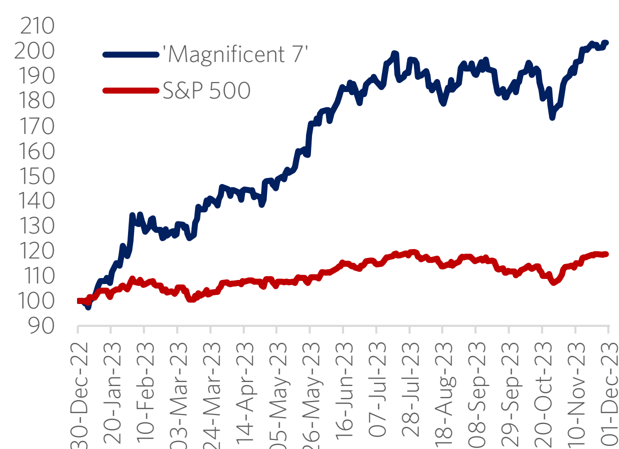


Source: Bank of America

While the overall 2023 performance of the US equity market may appear robust on the surface, a closer examination reveals that its strength is primarily attributable to a select few high-performing stocks. The exceptional gains observed in the share prices of the 'Magnificent 7' – comprising Amazon, Apple, Alphabet (Google), Meta (Facebook), Microsoft, Nvidia, and Tesla – were largely propelled by the pervasive hype surrounding Artificial Intelligence (AI) and a search for growth at a time when growth worries were triggered by the US regional banking crisis earlier this year. Despite this specific basket of seven stocks posting an impressive 103% year-to-date increase at the time of this report, the remaining 493 shares within the S&P 500 collectively experienced a 17% decline over the

same period. Consequently, the broader index registered a 19% gain so far in 2023 (see chart 3). This narrow-focused advancement in the US equity market prompts concerns about the sustainability of the upward trend into next year.

Chart 3: Weak US equity market breadth in 2023

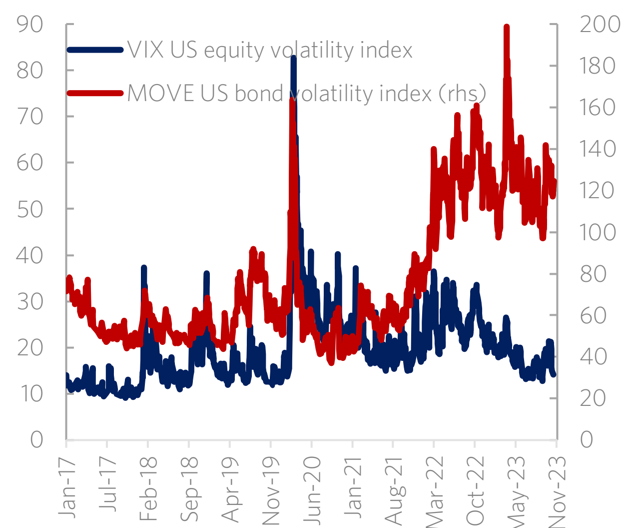


Source: Bloomberg, Momentum Investments

There has been a notable divergence between US equity and bond market volatility since the Fed's monetary policy tightening cycle started in early 2022. While bond volatility has settled at a higher level since then, equity volatility has declined to post-pandemic lows (see chart 4). This can be interpreted as indicative of equity complacency, with uncertainties about geopolitics, US growth, inflation and policy rates not appropriately reflected in equity volatility levels.

Research from Credit Suisse shows that when lots of good news and little bad news have been discounted historically by low US equity volatility levels, subsequent US equity returns have been constrained.

Chart 4: US equity market seems complacent about risks

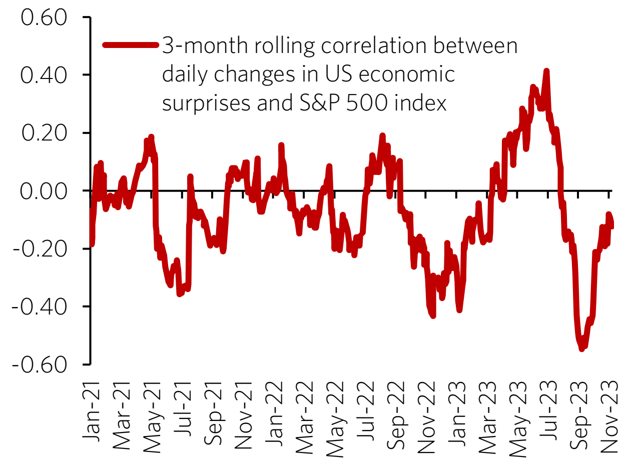


Source: Bloomberg, Momentum Investments

Good US economic growth news has constantly been bad news for US bonds since the onset of the rising US interest rate cycle in the early part of 2022, with a consistent positive correlation between US economic surprises and US bond yields ever since. This is also confirmed by real bond yields (and by implication policy rate expectations) being the main driving force(s) for global nominal bond yields throughout 2022-23, in contrast to rising inflation expectations pushing yields higher in 2020-21.

More recently, favourable growth reports have also become bad news for the US equity market, with positive economic surprises driving more negative policy rate expectations rather than more constructive profit views for US equities (see chart 5). As such, any indication of slowing US economic activity in 2024 with concomitant expectations at the time for the start of a US easing policy cycle in the not-too-distant future would provide some positive support to both the US bond and equity markets.

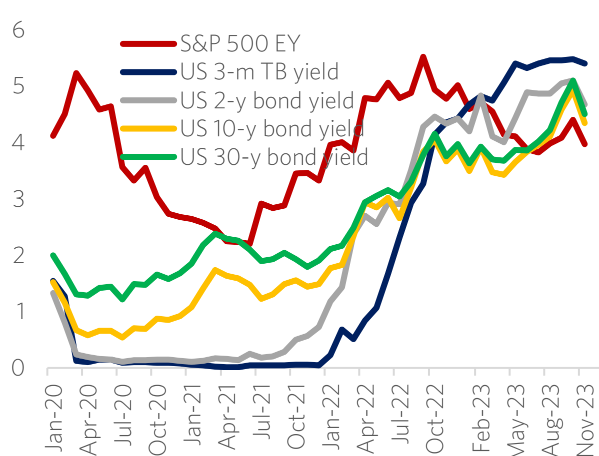
Chart 5: Good US growth news recently also negative for equities



Source: Bloomberg, Momentum Investments

Historically, US bonds have reacted favourably to a peak in the policy rate, with a consistently attractive bond return profile after the final US rate hike. Furthermore, since early 2023, the short end of the US fixed-income spectrum started providing superior income alternatives to US equities, with available yields on US cash and US 2-year Treasuries above those on US equities. From mid-2023, yields across the maturity continuum of the US yield curve have been higher than equity yields (see chart 6). This makes US fixed income a broader attractive asset class for investors in 2024, with an eventual move up the maturity scale likely required to address reinvestment risk in the run up to the likely start of a US rate cutting cycle later in the year.

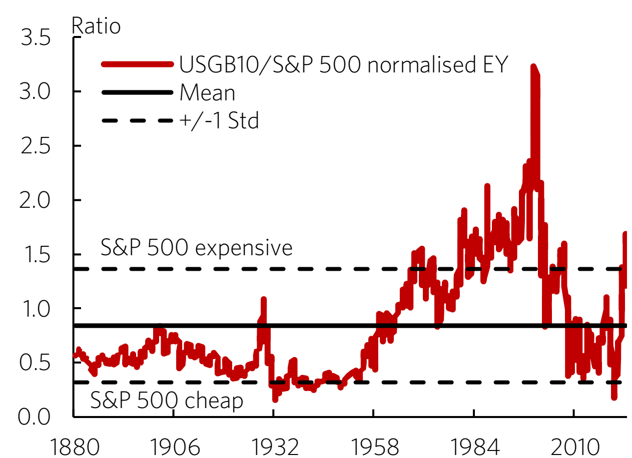
Chart 6: US fixed-income and equity yields



Source: Iress, Momentum Investments

Despite the general upward trajectory of US bond yields in 2023, fuelled by the resilience of the US economy, fiscal concerns and lingering inflation worries, there has been a notable absence of corresponding downward adjustments in US equity valuations. Consequently, US bonds are currently trading at a discount to US equities – an unusual occurrence in the 21st century. An analysis of the ratio of the present US bond yield to the through-the-cycle US equity earnings yield reveals that equities are now around one-and-a half standard deviations expensive relative to US bonds (see chart 7). This represents a departure from the prolonged trend observed since the GFC, during which US equities consistently traded comparatively inexpensively relative to bonds.

Chart 7: Relative US equity/bond valuations



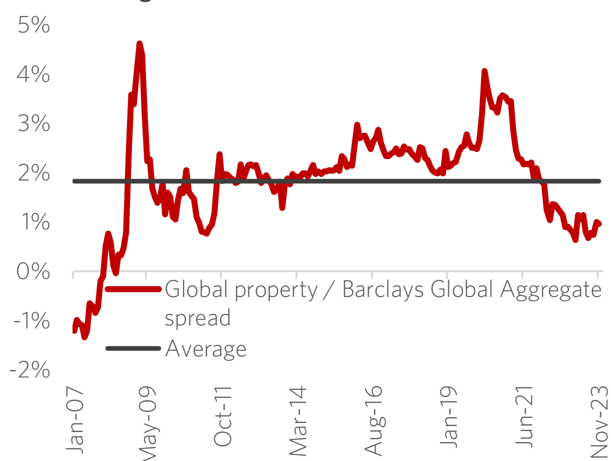
Source: Iress, Momentum Investments

With more fixed-rate debt at lower interest rates, the sensitivity of US real estate investment trusts (REITs) to interest rates has declined since the GFC and there has been no material deterioration in debt affordability yet. However, there is a risk for more distressed sales going forward due to higher debt levels associated with the rapid rise in interest rates and banks tightening lending standards to the commercial real estate sector.

Although global property currently looks cheap against global equities with yield spreads above historical averages after many years of poor relative performance, it still seems expensively valued versus fixed-income asset classes like nominal and real US Treasuries and

global investment grade bonds, with respective yield spreads below normal (see chart 8).

Chart 8: Global property expensive versus global investment grade bonds



Source: Bloomberg, Momentum Investments

The combined negative fundamental overhang of debt costs eventually resetting at higher interest rate levels and tight bank lending standards potentially squeezing the funding availability in the REIT sector, keep us circumspect about the global listed property sector for the moment. Nevertheless, we do acknowledge that the asset class brings diversification benefits and inflation protection to a multi-asset portfolio in the long run.

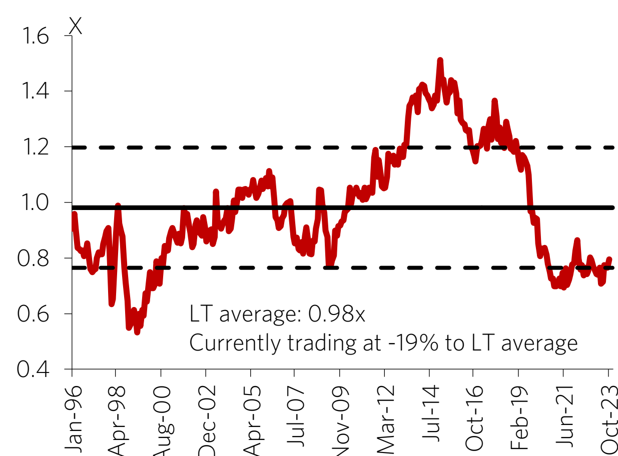
For SA investors, we prefer SA asset classes over global assets in the next year. SA assets are supported by more attractive valuations than global assets and discount copious amounts of bad news. Any improvement in global risk appetite during 2024 in the run up to future developed market (DM) policy rate declines, or better-than-expected outcomes on current local fundamental constraints, could unlock the valuation discount in SA assets. In addition, some rand appreciation associated with either of these outcomes would erode the local currency returns from global assets.

A significant risk premium is embedded in SA equity market valuations

It seems apparent from the ongoing rock-bottom valuations of the SA equity market that there is still little positive sentiment towards the asset class. Not only has SA been a longstanding superior dividend payer within emerging markets (EM), trading at an average 25% dividend yield premium to EM over the past two decades, its forward dividend yield premium has increased even further since the pandemic, to a current 50% premium.

Similarly, the current 21% SA forward P/E discount to EM is at a level last seen in the aftermath of the dotcom bubble in the early 2000s and significantly larger than the average 2% discount historically (see chart 9). With EM equities already trading at significant valuation discounts to DM equities, this makes SA equities even more cheap against the latter.

Chart 9: SA forward P/E relative to EM

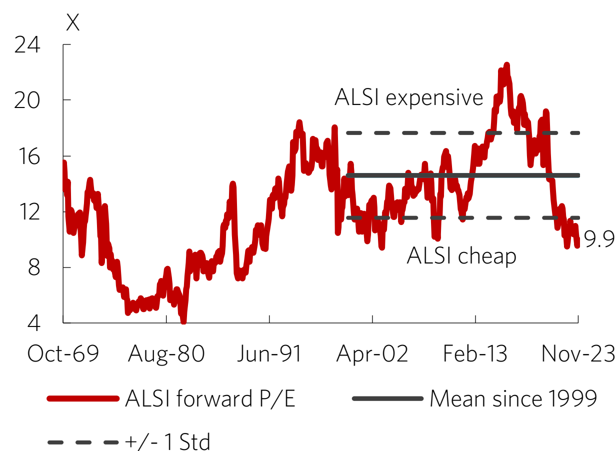


Source: SBG Securities

SA equities don't only look very cheap against the global universe as mentioned above, but also against their history. We estimate that the SA equity forward multiple is currently in single digits based on our conservative below-consensus 8% profit growth assumption for the next year, a level last seen in the aftermath of the GFC (see chart 10). Should we use the

higher double-digit consensus earnings growth number instead, the SA equity forward P/E would be at levels last seen in the early 2000s.

Chart 10: ALSI forward P/E

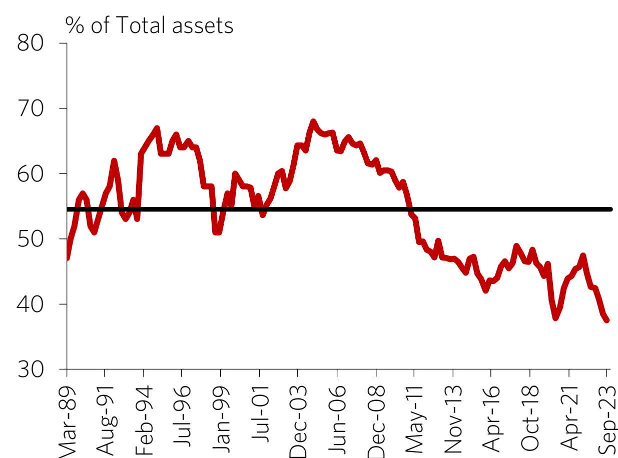


Source: Iress, Momentum Investments

It can be argued that the significant risk premium currently embedded in SA equity valuations is mostly self-inflicted through the continual deterioration of basic operational infrastructure in the SA economy over many years, particularly electricity unavailability and rail transport degradation. However, it also implies that there is ample scope for a rerating in SA equities should there be an improvement in some of these constraints over time, as an ongoing dire scenario is already fully discounted. A rerating could also be on the cards should a global risk-on environment take hold.

In addition, SA equities are very underowned by local and global portfolio managers, which implies that there is no overhang in the asset class, enhancing its rerating potential. SBG Securities notes that domestic multi-asset fund managers' 37.5% SA equity weighting in the third quarter of 2023 is now below the Covid lows (37.8% in the second quarter of 2020) and the lowest since sanctions were imposed on SA in 1986 (see chart 11). SA is also the fifth most underowned market within global EM (GEM) equity funds and as such should have meaningful rerating potential from current cheap valuations whenever global risk appetite improves.

Chart 11: Historically low SA equity exposure in domestic multi-asset funds



Source: SBG Securities

SA bonds also discount lots of bad news

Real DM bond yields have recovered from very negative levels due to rising nominal yields and falling inflation in 2023. However, with the exception of the US where real bond yields are now slightly positive, real yields in the rest of the region remain in negative territory. In contrast, real bond yields in the EM world are significantly in positive territory. Among the investable EM countries, Brazil and SA continue to stand out as providing the highest available real bond yields based on current nominal yields and the latest inflation print (see table 1).

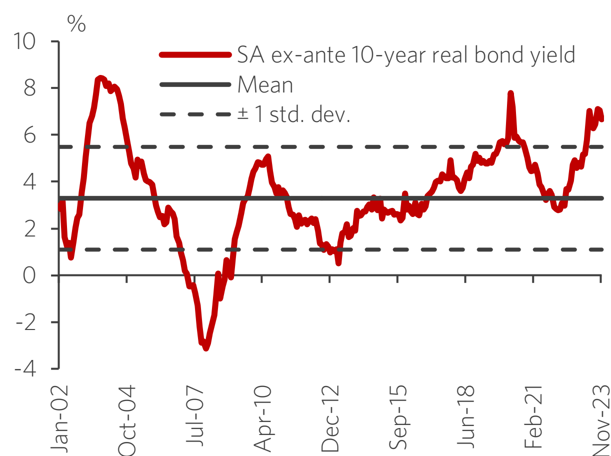
Table 1: Real ex-post 10-year government bond yields

DM	
US	1.2%
Europe	-0.4%
UK	-0.4%
Japan	-2.5%
EM	
Brazil	6.2%
South Africa	5.5%
Russia	5.3%
Mexico	5.2%
Türkiye	-34.8%

Source: Iress, Momentum Investments

Not only are SA real bond yields currently attractive versus DM and EM yields in absolute terms, but SA's real yield premiums against DM are also high against historical averages (e.g. almost one standard deviation above the average versus the US since the advent of SA's inflation targeting regime). Furthermore, SA's prospective real bond yield is now more than one-and-a-half standard deviations higher than its historical average since inflation targeting (see chart 12). In our view, SA's high nominal and real bond yields already discount elevated fiscal and country risk premiums. Indeed, the current implied total SA risk premium (sovereign and fiscal) derived from the differential between current nominal bond yields, US real rates and SA expected inflation, has only ever been higher at the height of Covid in 2020. Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013.

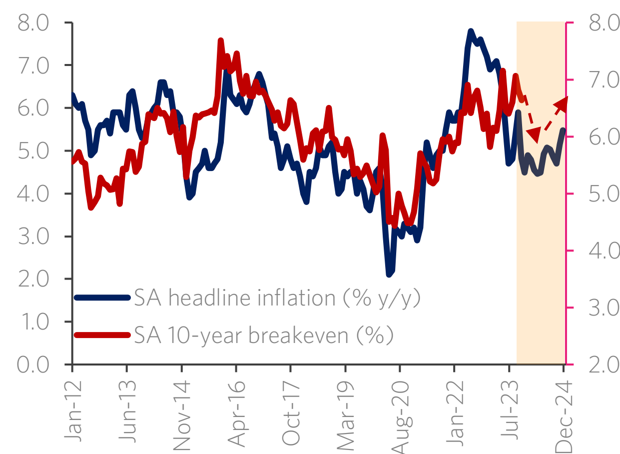
Chart 12: SA ex-ante real bond yield



Source: Iress, Momentum Investments

We expect ILBs to progress from experiencing lower-than-average monthly accruals in 2023 to benefiting from higher-than-average accruals in 2024. After break-even tightening in the first half of 2024, a second half of 2024 widening is anticipated in line with the projected inflation trend. This should provide more fundamental support for ILBs as 2024 unfolds (see chart 13).

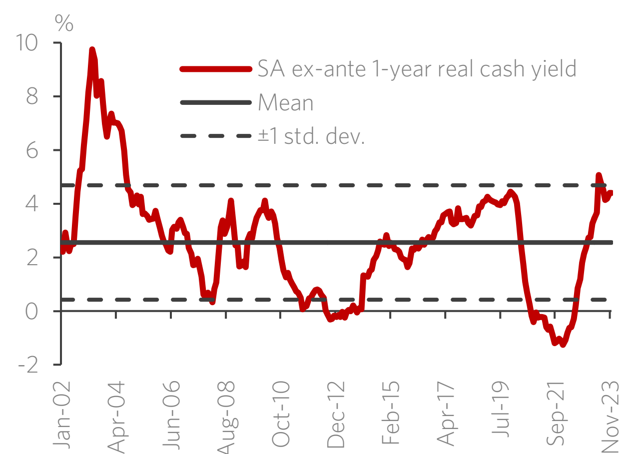
Chart 13: More fundamental support for ILBs as 2024 unfolds



Source: Iress, Momentum Investments

The prospective SA real cash yield has been rising from a low level in line with policy rate increases and recently expected falling inflation and is currently at an attractive 0.9 standard deviations above its historical average (see chart 14). Similar to the case for US cash, we anticipate that investors will need to increase SA fixed-income duration during 2024 to counter the rising reinvestment risk of shorter-duration fixed-income assets such as cash as we approach the start of the local rate cutting cycle.

Chart 14: Prospective SA real cash yield



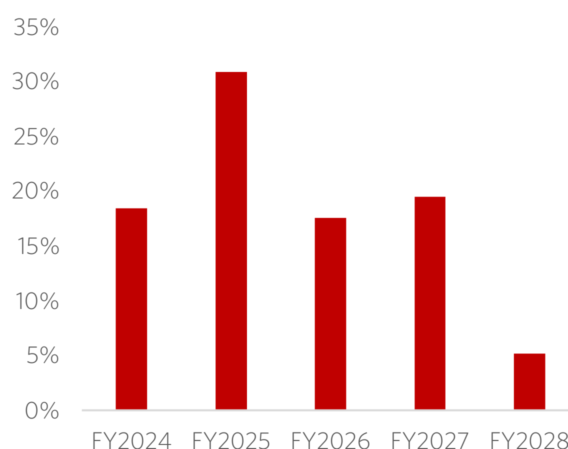
Source: Iress, Momentum Investments

Listed property value is evident, but fundamental risks remain

Although Cape Town office rentals have been rising in recent years, even in real terms, Johannesburg remains the largest and hence most important office node by far – here rentals have remained stagnant in nominal terms and are still falling in real terms. At least office vacancies don't seem to be at risk from new excess supply, with a controlled and demand-driven recent supply of space. Falling industrial vacancies have driven positive rental growth in this subsector, but falling business confidence could be a harbinger of rising industrial vacancies in the near term.

Worryingly, the delayed impact of higher interest rates is starting to hurt the SA listed property companies, with recent earnings guidance negatively impacted amidst future interest rate hedge expiries, particularly in 2025 (see chart 15). There is thus upside risk to property debt costs in the offing, with a repricing to higher market rates as interest rate hedges expire and debt matures in the coming years.

Chart 15: SA listed property average hedge maturities



Source: Company reports, Momentum Investments

SA listed property nominal and real dividend yields are among the highest in the world. However, return upside from attractive valuations needs to be weighed against the above-mentioned negative fundamental risks when deciding about portfolio exposure to this asset class.

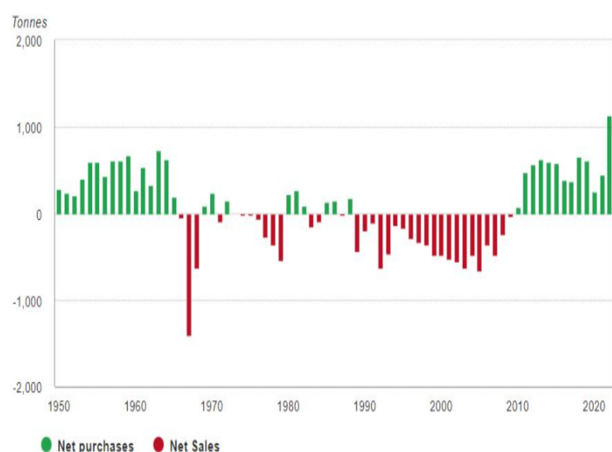
Geopolitics and related central bank gold buying the dominant drivers for the gold price

For the decade and a half up to the start of the Russia/Ukraine war in the beginning of 2022, US real interest rates were the main determinant of the direction of the US dollar gold price. This was related to the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset. Interestingly, we have found that movements in the US dollar did not provide additional explanatory power for the behaviour of the dollar gold price during that time.

However, since the Russia/Ukraine war and the resultant financial sanctions imposed on Russia by the West, the relationship between the gold price and US real interest rates has broken down, with the gold price unfazed by the significant rise in US real yields since then. As a result, the dollar gold price is currently more than three times higher than would be expected at prevailing real interest rate levels.

This divergence of the gold price from the US real interest rate fundamental driver since the start of the Russia/Ukraine war can be ascribed to the highest gold buying from global central banks in 55 years in 2022 (see chart 16), probably for geopolitical and diversification reasons. Gold enables central banks to diversify their reserves away from assets like U.S. Treasuries and the dollar and, unlike currencies and bonds, it does not rely on any issuer or government. Banks including those of Turkey, China, Egypt and Qatar said they bought gold last year. But around two-thirds of the gold bought by central banks last year was not reported publicly, according to the World Gold Council (WGC). This trend has continued in 2023, with central bank buying in the first three quarters of 2023 the highest on record, dominated by China, Poland and Singapore.

Chart 16: Central bank gold buying highest ever in 2022

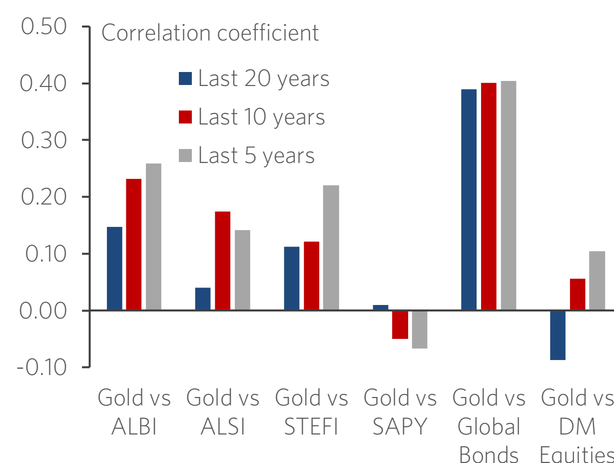


Source: Refinitiv, World Gold Council

With geopolitical strife likely to remain high in coming years as deglobalisation continues and a multipolar world order establishes itself (between the West and China), gold is likely to maintain its strategic attractiveness in central bank and investment portfolios as a hedge against political volatility and uncertainty. This is borne out by results from a recent WGC survey where 71% of 57 global central banks indicated that their gold reserves will likely increase in the next 12 months. The People's Bank of China, in particular, has significant scope for increasing its gold exposure, with only 4% of its reserves currently consisting of gold. This is in contrast to other EMs like Russia and Turkey, where gold accounts for around 25% of total central bank reserves, and DMs like the US and Germany with around two-thirds of reserves in gold.

Gold also has a strategic rationale as a portfolio risk diversifier, because it is expected to hold its value through turbulent times and has limited correlation with other asset classes (see chart 17). Furthermore, for a SA investor, the rand gold price has been a strong relative asset class performer historically, as perennial rand weakness has provided huge support over many years.

Chart 17: Gold has a limited correlation with other asset classes



Source: Iress, Bloomberg, Momentum Investments

Global and local risks in 2024

According to The Economist, 76 countries (representing more than half the world's population) will have some sort of election (national, regional or local) in 2024. Many of these elections are taking place in countries that cannot remotely be characterised as democracies and thus are unlikely to be either free or fair. However, some elections have the potential to induce substantial volatility in either broader global financial markets due to their universal significance (US and Taiwan) or at least in their own markets due to their idiosyncratic importance (UK, India and SA).

Escalation of the Russia/Ukraine war or of the conflict in the Middle East remain serious global risks for 2024.

Other geopolitical hot spots in the year could be a more hostile stance by China on Taiwan, trade friction flare ups between the US and China or more serious provocations by North Korea.

Renewed financing pressures in China's property sector with wider consequences for the financial sector and economy could also be destabilising for financial markets.

Potential populist posturing from some of SA's political parties in the run up to the national general election could induce some short-term investor fears occasionally. More importantly though, should the election outcome entail the formation of a more

populist coalition government, this would more permanently increase the risk premium required for SA as an investment destination.

Disappointments in the coming year in terms of expected improvements in the magnitude and frequency of Eskom's loadshedding schedule, addressing the operational issues at Transnet or progress on economic reforms, could furthermore lead to local market instability periodically.

The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at momentum.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.