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WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

Nick Downing

The anatomy of a bear market: Earnings next

Global equity markets are fixated on the Federal Reserve "pivot." Investors appear glued to every detail of every speech delivered by Fed Chair Jay Powell and members of his policy committee, the Federal Open Market Committee. Interest rates are important, they affect economic activity and they set the discount rate used to price company earnings, but where would we be without earnings. Earnings are even more important than interest rates and monetary policy. They ultimately drive dividends and share prices. Markets go through cycles of falling and rising interest rates but over time they keep rising in line with earnings growth.

The third quarter (Q3) earnings season has kicked off in the US. There have been some high-profile earnings misses and profit warnings, including Advanced Micro Devices, FedEx Corp, Nike, and CarMax. In 2020 and 2021, there was a global shortage of semiconductors, logistics capacity, trainers, and vehicles, amid a fiscally driven surge in demand. Demand is now easing rapidly as inflation cuts into household disposable income and companies are battling to pass higher costs onto their customers. Revenues are slowing and profit margins are shrinking.

Analysts have been steadily cutting earnings forecasts. At the start of the quarter, the consensus Q3 forecast for the S&P 500 index was year-on-year revenue growth of 9.7% and earnings growth of 9.8%. The revenue growth forecast has slipped to 8.7% while earnings growth has reduced sharply to 2.9%, indicating substantial margin pressure. According to FactSet, this represents the largest cut to earnings estimates within a reporting period since Q2 2020, at the peak of the Covid outbreak. Excluding energy, Q3 earnings would be even worse, predicted to decline by 3.8%.

Companies are facing slowing demand and rising costs, as well as difficult year-on-year comparisons. The deteriorating outlook is being compared with extremely buoyant conditions a year ago. The surging dollar is also reducing the value of overseas earnings. The dollar index has gained by 20% since the start of the year and 40% of S&P 500 revenues come from outside the US. A strengthening dollar lowers the value of foreign revenues and reduces global competitiveness.

The technology sector, which comprises around 40% of US equity markets, has the greatest proportion of foreign earnings. Materials and consumer staples are not far behind, while sectors with the greatest domestic exposure are the banks, financials, utilities, and real estate. Retailers tend to import a lot and so a strong dollar should help them mitigate other cost pressures. Profits recessions favour the more defensive sectors, such as consumer staples, utilities, and healthcare, which people cannot do without.

The S&P 500 index has declined by over 24% since the start of the year. Price-earnings valuations have returned to their long-term average. The estimated 12-month forward price-earnings multiple has dropped from 21x at the start of the year to 15.9x. This is below the 5-year average of 18.6x and the 10-year average of 17.1x. It lies close to the 20-year average of 15.7x. The big question: How accurate is the current 12-month forward PE multiple? After all, it is based on earnings estimates and we have seen how quickly the Q3 estimate has unwound. There is a strong likelihood that earnings forecasts will decline further. Interest rate hikes have an impact delay of 6-12 months and so their effect on earnings may only be felt in 2023.

We should not be surprised if there is an earnings recession. The Fed has stated its commitment to bringing down inflation and that it is willing to incur some pain in the process. JP Morgan CEO Jamie Dimon said on 10th October that the US and global economy could dip into recession by the middle of next year. Earnings will likely contract but the good news, in the US at least, is that a recession will be short and shallow. Banks, companies, and households spent the decade after the 2008/09 Global Financial Crisis mending their over-leveraged balance sheets. The deleveraging process combined with massive excess savings accumulated during the Covid pandemic has removed any structural imbalances. The economy is well equipped to deal with a cyclical downturn.

Bear markets typically suffer two down-legs. The first commonly arises after an economy overheats and monetary conditions need to be tightened. Interest rates rise causing a compression in equity market price-earnings multiples, resulting in a 15-20% market decline. At this stage economic growth can remain buoyant as it takes time for higher interest rates to take effect. A continuation of buoyant conditions often leads to a powerful relief rally, like the one that occurred between the mid-June and mid-August this year. A 15-20% market decline is often followed by a swift 10-15% recovery. The second leg lower takes place if earnings decline and depending on the severity of the recession can lead the market lower by another 15-20%. A new bull market will invariably be born while earnings are still dropping. The price earnings multiple will increase as the market looks through the recession to the recovery ahead, usually due to monetary and fiscal stimulus, and regulatory reforms.

Jamie Dimon said the S&P 500 could fall by “another easy 20%” from current levels, as earnings decline. This would result in exceptional investment opportunities. OAM’s portfolios are defensively positioned with substantial dollar cash holdings accumulated over the past 15 months as the bear market has unfolded. Portfolios can withstand the earnings recession and will exploit the investment opportunities that emerge.

Local Report

Gielie Fourie

Demographics

INTRODUCTION: Demographics drive the world; it cannot be otherwise. The effect on the economy boggles the mind. Financial consultants must always inform their clients: “Past performance is not indicative of future results.” True, the past is not the perfect prologue to the future, but knowing the past helps us to understand the future. Demographics is a powerful change agent, capable of shaping our future by stealth.

Our demographic change, one may call it a crisis, is not a projection of the future. It is happening right now. Italy's reality may be funny if it was not so sad. By 2050, 60% of Italians will have no brothers, sisters, cousins, uncles, or aunts. The Italian family, with the father who pours the wine and the mother who serves the pasta to a table of grandparents, grandchildren, and greatgrandchildren, will be gone, as extinct as dinosaurs. Yemen, on the other hand, a failed country in the middle of a terrible civil war, will show a population increase that is double Italy's.

Africa will see a population explosion. Fewer babies will be born in all of Europe in 2023 than in Nigeria alone. More than half the increase of the global population projected by 2050 will be concentrated in just eight countries, mostly in Africa, according to The Economist: Congo, Egypt, Ethiopia, India, Nigeria, Pakistan, Philippines, and Tanzania. Nigeria will have more inhabitants than Europe and the United States. Demographics will change the face of Africa. (Source: Dennis Gartman Newsletter 29 September 2022).

AFRICA WEALTH FORECASTS: Total private wealth held in Africa is expected to rise by 30% over the next 10 years, reaching US$2.6 trillion by 2030. This growth will be driven by robust growth in the billionaire and centi-millionaires' segments. First, during this period Africa's strongest wealth growth is expected to come from Ethiopia, Mauritius, Rwanda, Kenya, and Uganda with 60%+ growth rates. Second, solid wealth growth is forecast in Namibia, Botswana, Mozambique, and Zambia with 40%+ growth rates. Last, moderate wealth growth is expected from South Africa, Ghana, Côte d'Ivoire, Egypt, Morocco, Tanzania, Angola, and Nigeria over the forecast period with 20%+ growth rates. The overall 30% growth forecast for Africa is relatively healthy when compared to most other regions globally. (Source: AfrAsia Bank AFRICA WEALTH REPORT 2021).

AFRICA'S WEALTHIEST CITIES: Johannesburg is the wealthiest city in Africa. Johannesburg's wealth is largely concentrated in Sandton, which is home to the JSE (the largest stock market in Africa) and to the head offices of most of Africa's largest banks and corporates. Major sectors in the city include financial services (banks) and professional services (law firms, consultancies).

Cape Town is home to Africa's most exclusive suburbs including Clifton, Bantry Bay, Fresnaye, Llandudno, Camps Bay, Bishopscourt and Constantia. Also, home to several top-end lifestyle estates including: Steenberg, Atlantic Beach and Silverhurst Estate. Major sectors there include real estate and fund management. Then follows the other wealthiest cities: Cairo, Lagos, Africa's largest city, Durban and Umhlanga, Nairobi, the economic hub of East Africa, and Paarl, Franschhoek and Stellenbosch. These three towns are located next to one another. Combined they form one of the fastest growing areas in South Africa for High Net-Worth Individuals (HNWIs).

SPOTLIGHT ON SOUTH AFRICA: South Africa is home to the largest luxury market in Africa by revenue, followed by Kenya and then Morocco. Major components of this include luxury hotels and lodges, luxury cars, luxury clothing and accessories, luxury watches, private jets, and yachts. Unfortunately, this is changing. SA's performance has been poor, with total private wealth held in the country declining by 25% over the past decade, when measured in US$ terms. Performance was negatively impacted by a significant loss of currency value vs. US$ from around R6.80 per US$ in 2010 to R14.70 in 2020 (year-end rates). The current rate is R17.65 to the US$. This led to poor returns from the JSE all share index - down by 12% over the past decade when measured in US$ terms.

BOTTOM LINE: South Africa's population growth has slowed down. The ongoing migration of wealthy individuals out of the country has contributed to our mediocre economic performance. Based on AfrAsia's estimates, around 4,200 HNWIs have left SA over the past decade (2010 to 2020). Most individuals (including our children, brothers, and sisters) have gone to the UK, Australia, and USA.

Some have also gone to Switzerland, Israel, Mauritius, New Zealand, the UAE, Canada, Portugal, Spain, Cyprus, and Malta. The upshot is a sluggish local prime residential market. Homes valued at over R10 million have become exceedingly difficult to sell. We cannot escape the negative effects of demographics. To protect your wealth, it is crucial to invest a percentage of your assets offshore. We can help you with offshore investments – the majority of our clients' investments are offshore. Contact one of our highly qualified consultants for gratis advice.