WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

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Reconciling the global equity rally

Given the gloomy analyst forecasts at the start of the year, it may surprise many that the MSCI All Country World Index is up year-to-date by 13% (in US dollar terms). A lot of the rally has been centred around a handful of giant US technology stocks that are believed to be the big winners in Artificial Intelligence. However, the rally is broadening across other shares and other regions.

The broadening global equity rally appears at odds with the near consensus forecasts of impending recession. Recessionary signals are widespread. Inverted yield curves suggest central banks have over-tightened interest rates. They indicate sharp interest rate cuts to come as the delayed impact of rate hikes take their toll. Oil and commodity prices are weakening. Credit conditions are tightening, and credit demand is weakening.

The rally might be attributed to growing confidence that central bank interest rates are close to their peak. After all, inflation has already peaked and is gradually declining. US consumer price inflation receded in May to a more than two-year low of 4.0% year-on-year, down from 4.9% in April. However, the detail behind the data is less straight forward. Most of the decline is due to sharply falling energy prices. Core inflation, excluding food and energy prices, dipped by far less from 5.5% to 5.3% and maintained its month-on-month increase of the prior two months at 0.4%. Core goods prices, which fell steadily in 2022 as supply chains were repaired, have reaccelerated rising in both April and May by 0.6% on the month. Core services inflation, scrutinised by the Federal Reserve, due to its close association with wage pressure, remained firm at 0.4% on the month the same increase as in April and March.

Inflation is clearly stickier than most had predicted, including the Fed and most central banks. In acknowledgment, the Fed at its latest policy meeting on 14th June increased its projected terminal fed funds rate yet again. This is the fourth upward revision in the current monetary tightening cycle. Most Fed participants now project a further 50 basis point increase will be needed before year-end.

Yet, sticky inflation may be a key reason behind the global equity rally. Inflation lends pricing power to companies. During the first quarter in the US, 78% of companies representing the S&P 500 index beat consensus earnings forecasts and earnings projections are being ratcheted higher. Independent global investment research firm, Alpine Macro believes “relatively high inflation may offer some protection to nominal earnings.” Earnings are always reported in nominal terms unlike GDP data which are always reported in real terms after adjusting for any distortion caused by inflation or deflation. According to Alpine Macro, since corporate revenue and profits are nominal variables, rising prices should help rather than hurt corporate profitability. Indeed, nominal GDP is a close proxy for corporate revenues. Nominal GDP growth can remain positive even when the US economy enters recession, especially if it is shallow and short-lived as most analysts are predicting.

Recessions in the 1970s and 1980s were severe, but earnings per share drawdowns were much milder than those in recent decades when low inflation prevailed. Alpine Macro makes a strong case: "Assuming a mild (US) recession reduces annualised real GDP to 0% and inflation falls by an additional 150 basis points by year-end, nominal GDP would still be growing at around 4%, which is the same as the average nominal growth rate during periods of normal economic expansion since the Global Financial Crisis. Moreover, operating earnings per share growth was 12.3% during this period."

The caveat to the constructive outlook is that inflation does not reaccelerate. Equity markets should remain buoyant even if inflation is sticky at around 4% but a reacceleration, although unlikely, would be met with another damaging cycle of central bank tightening.

Local Report

Gielie Fourie

Food retailing

INTRODUCTION: Food retailers are struggling, some more than others. There are several reasons for this. The food market is competitive - increased competition leads to thinner profit margins. Consumer preferences changes and new shopping habits are continually evolving. Other factors include increased online competition, higher operating costs, supply chain disruptions, and changing market dynamics like economic fluctuations, inflation, and changes in government regulations. In South Africa we can add loadshedding, and our strict labour laws. The four largest supermarket retailers have spent nearly a combined R3 billion on diesel over the last nine months to enable them to run generators so they could trade through the near-constant loadshedding. The Covid pandemic lockdowns that started three years ago in March 2020 were a severe setback. The share prices of only two of the big four food retailers, Shoprite, and Woolworths (Woolies), have returned to pre-Covid levels. We look at three large retailers with exposure to food retailing.

SHOPRITE: Shoprite Holdings, with its combined subsidiaries, is the largest fast-moving consumer goods (FMCG) retail operation on the African continent. The group enjoys a presence in 16 countries across Africa through its various brands including Shoprite, Checkers, Usave, OK, House & Home and Hungry Lion.

For the year ending 30 June 2022, Shoprite's core South African supermarket segment, which accounts for 80% of its sales, increased sales by 10.1%. For the 26 weeks ended 31 December 2022 Shoprite's total sales increased by 16.8% to R102 billion (2022 R91 billion). HEPS was up 10.2%. To achieve this in an economy that grew by only 1.9% in 2022 is outstanding. Its on-demand one-hour delivery app Checkers Sixty60 continued to innovate and grow its sales. Shoprite is trading at R227.00. It has a market capitalisation of R135 billion, a PE ratio of 20.50x, a dividend yield of 2.70%, a return on equity of 24%, a return on assets of 9.75% and a Price/Book ratio of 4.8x. The share price is up 118.67% over the last three years, well above pre-Covid levels. The consensus forecasts of analysts consider it as a Hold.

SPAR: Spar was hit by a perfect storm. It experienced a wave of negative publicity in 2022, including allegations that it manipulated the value of stores – the standards of its governance were questioned. The board said it takes allegations of fictitious and fraudulent loans extremely seriously. SPAR denied allegations of 'dodgy' accounting. It led to a board shakeup in January 2023. CEO Brett Botten stepped down at the end of January 2023, while the chairperson, Graham O'Connor, departed in February 2023 amid reports of fictitious and fraudulent loans, and 'dodgy' accounting. The non-executive chair, Mike Bosman, took on the role of Executive Chairman and "very short-term" interim CEO to strengthen governance. A permanent CEO has not yet been appointed.

Spar's operations in Poland came under pressure due to increased competition and rising costs. Spar Poland is lossmaking. Of the 180 Spar stores in Poland, 58 stores left the group in 2022. The Russia-Ukraine war added to its woes. Poland shares a border with Ukraine. Spar only expects its Polish venture to breakeven in 2024. Spar's implementation of SAP software at its KwaZulu-Natal distribution centre was a disaster. The group suffered R786-million in lost wholesale turnover in the six months to end-March 2023. Implementing new software carries risks. Loadshedding has cost Spar more than R700-million in diesel for generators over the latest six-month period. Spar announced on 1 June 2023 that it expects its HEPS for the six months to March to decline by between 25% and 35%. Spar is trading at R103.00. Spar has a market capitalisation of R20 billion, a PE ratio of 8.89x, a dividend yield of 3.88%, a return on equity of 15.91%, a return on assets of 4.54% and a Price/Book ratio of 1.89x. The share price is down 40.04% over 3 years, still far below pre-Covid levels yet the consensus analyst forecast is a Buy.

WOOLWORTHS: Roy Bagattini, former executive vice-president of Levi Strauss, took over from Ian Moir as group CEO of Woolies on 17 February 2020. In December 2022 Woolies finally sold its Australian operation, David Jones, that it acquired in 2014. The sale removed about R22 billion of debt or liabilities associated with the purchase of David Jones from the balance sheet. The share price was R70.00 in 2014 when it acquired David Jones, the same price that it is today.

The sale of David Jones changed Woolies' financial profile significantly. The balance sheet has been transformed – it is the strongest it has been for the better part of the last ten years. Profits have improved - for the six months to the end of December 2022, Woolies reported its biggest first-half profit ever. Dividends are up by almost 100%. After dividends have been paid the total cash position is so healthy that Woolies has implemented a programme of share buybacks. 90% of Woolies stores have backup power. Roy Bagattini has proved his skills as a turnaround specialist. Over the last three years the share price is up 109.7%, well above pre-Covid levels. Woolies shares are trading at R71.00. It has a market capitalisation of R70 billion, a PE ratio of 16.39x, a dividend yield of 4.29%, a return on equity of 44.70%, a return on assets of 10.59% and a Price/Book ratio of 5.39x. The consensus analyst forecast consider Woolies a Buy.

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