ASSET MANAGEMENT

House View

Global Earnings Outlook – Headwinds are building

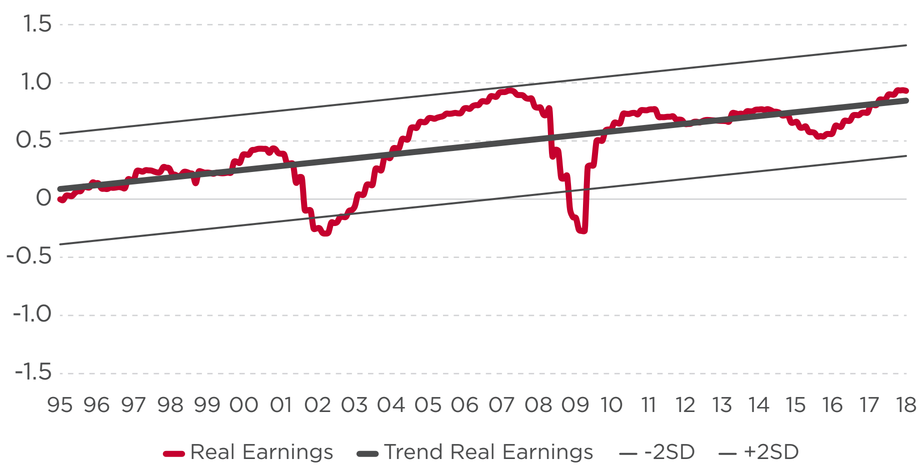
This article was supplied by Cadiz Asset Management, the designated asset manager for Warwick Wealth clients.

In the last quarter of 2018, risk assets (including both local and international equities, property and commodities) had a torrid time as investor concerns around a possible global recession and other global risks heightened. Fortunately, calm has returned to markets, resulting in these same risk assets rebounding at the start of this year. After enjoying nine years of strong earnings growth from a very low base following the Global Financial Crisis in 2008, and more recently experiencing strong growth since 2016, there seems to be an inflection point in the business cycle where we expect earnings growth to slow to trend-growth. Tailwinds that have supported earnings growth are beginning to fade. As a result, we don't expect earnings to experience the strong growth enjoyed between 2004 and 2007, as seen in Figure 1.

Understanding where we are in the earnings cycle and the risks to earnings is crucial, because in the long run, stock prices tend to follow earnings. Understanding the risks to earnings growth at the stock level, industry level, as well as the market level, is helpful in assessing where possible risks may lie.

In this issue

Figure 1: MSCI World Real Earnings 1995 to 2018 (Log scale)



Source: Cadiz Asset Management and Bloomberg

Global earnings growth expected to slow to trend-growth as tailwinds become headwinds

Tailwinds that have supported the strong earnings cycle have included historically low interest rates, low oil prices, low wage growth (since employment levels were low), and more recently, tax cuts. This has allowed profit margins to reach historically high levels in the US. These tailwinds are now fading and likely to become headwinds over the next two-to-three years. »

Looking at these drivers more closely:

- Wage pressures are building. With low unemployment levels, skilled labour is becoming scarce, thus allowing employees to demand higher wages. Wage inflation in the US (currently 3%) has been rising slowly and is expected to accelerate further. Price inflation for goods and services is currently 2%. If wages continue to grow faster than prices of goods and services, it will start to impact profit margins, which are at historically high levels.
- Fuel costs are expected to increase as oil prices have risen from a low of $25 per barrel of Brent Crude oil, to above $60 per barrel.
- Debt servicing costs are expected to increase as interest rates rise. On aggregate, corporates have increased their debt levels, taking advantage of cheap debt and extending the maturity dates when this debt needs to be repaid. This has weakened corporate balance sheets, which could become a major risk in the medium-term if borrowing rates are raised significantly higher.
- Last year, the US government cut personal and corporate taxes. This encouraged increased consumption, resulting in revenue growth for companies, as customers bought more of their products. At the same time, corporates paid less tax, boosting earnings growth by 7%. This is unlikely to be repeated.

Global trade, increased tariffs and tensions between US and China are further risks to earnings

Concerns around global trade have created considerable uncertainty for companies as the rules of engagement are being redefined. The US is in the process of renegotiating a number of trade agreements with China and other countries. Additionally, the BREXIT outcome is also likely to affect trade. An uncertain economic environment does not encourage businesses to invest or expand their businesses. Increased investment is one way for companies to improve efficiencies, reduce costs and grow profits. We expect investment growth to be subdued until there is more clarity and stability on trade policy.

A more direct impact to earnings has been the increased tariffs imposed by the US on various imported goods from China and other countries. These increased import tariffs have affected certain industries more than others and have caused various input costs to increase meaningfully, thereby placing pressure on profit margins. Companies do have scope to source goods elsewhere, but this has implications for their regional and global supply chains, which are being disrupted. We expect tensions between the US and China to be ongoing and will be a major risk to future global growth and company earnings.

Faced with these headwinds, we expect earnings growth to slow and grow in-line with trend-growth. Risks to this view have, however, certainly increased.

In this environment, we continue to favour quality businesses that have a competitive advantage; high barriers to entry; can maintain their pricing power; have economies of scale and/or excellent distribution networks. These quality companies are more likely to navigate the risks mentioned above and have proven track-records of generating higher returns on capital for shareholders. This enables them to grow their earnings and the value of their companies over time.

At Cadiz, we focus on buying these quality businesses at attractive prices, when we believe there is a sufficient margin-of-safety to limit the potential for losing your capital. We continue to remain disciplined in allocating capital to both local and offshore opportunities to achieve the fund's investment objective of compounding your wealth over time and while limiting any permanent loss to your capital.

International Market Overview

International markets had a stellar start to the year, with all major indices ending the period in the black for the first three months of the New-Year. The first quarter of 2019 was accentuated by a review of the US Federal Reserve's monetary policy stance, the ongoing battle in the UK with regard to their Brexit from the EU, as well as continued concerns about the slowing Chinese economy.

United States of America

The American markets ended the first quarter on the front foot, with the S&P 500 showing a gain of 13.1% (one of its biggest quarterly gains since the third quarter of 2009), the Dow Jones up by 11.2% and the Nasdaq by 16.5%. As mentioned previously one of the biggest talking points was the US Fed, during their March meeting, inferring the likelihood of it raising rates during 2019 was almost nil. The Fed also indicated that it would slow the rate of tapering from $30 billion a month to $15 billion in May, which is expected to end totally in September. Sentiment with regard to the trade talks with China and increasing optimism around the possible success of such talks, further boosted market sentiment as proposals made by the Chinese went further than previous discussions.

Economic data released during the quarter, has indicated that potentially the US economy might be losing momentum as the GDP data for the fourth quarter came in at 2.4% as opposed to an expected 2.6%. Consumer spending (a key component of economic measure) had rebounded less than anticipated in January. Furthermore, incomes only advanced at a moderate pace in February as personal income rose by 0.2% as opposed to a 0.1% in January.

Europe

European markets were carried along by the exuberance of the American markets, with the buoyancy remaining strong. This was compounded by the release of positive economic data coming from Europe's strongest economy, Germany, and the positivity engendered by the headlines in respect of the US-Sino trade talks. In its latest assessment, the European Central Bank revised its growth estimate for 2019 downward to 1.1% from 1.7% but kept their 2020 expectations the same. In the same breath, the ECB indicated its intention to keep the key rates unchanged for the rest of 2019 but, could extend this further in its pursuit of price stability.

The FTSE 100 ended the quarter higher by 8.2%, even as the possibility of a 'no-deal' Brexit became more likely after the third parliamentary rejection of Prime Minister May's EU plan. The original 29th March deadline has been extended to the 12th April by the EU, leaving the two likeliest options on the table expected as being that the UK either a) leaves the EU with no deal at all, or b) agrees to a lengthy extension to allow time for the implementation of a new approach. This uncertainty has cost the economy, however, as many businesses have moved offices, staff assets and legal entities from the UK to the EU.

The DAX 30 also ended the quarter higher by 8.9% as economic data late in March boosted investor sentiment. The German Business confidence improved for the first time in seven months, with the indicator rising to 99.6, higher than the previous months 98.6, and better than expected. This increase mitigated the negativity induced by the PMI released a few weeks earlier which had pointed to the German economy possibly starting to slow down, a similar trend as seen in China and the US.

Asia

Asian markets, like their western counterparts, also had a stellar quarter with the Nikkei 225 ending the period higher by 8.4%, the Hang Seng by 12.4%, and the Shanghai Composite by a significant 25.4%.

In Japan, economic data indicated that the contraction of the Japanese manufacturing activity had taken place at a slower-than-anticipated rate, even as output had fallen at its sharpest rate in almost three years. This weakening was further borne out by the March Tankan survey released by the Bank of Japan, showing worsening business confidence among their biggest manufacturers for the same period.

Chinese growth has been revised downward from 6.5% in 2018, to between 6.0% and 6.5%, and it is likely that the weakness has been largely prompted by the US-Sino trade war, with Chinese exports to that market dropping by 15% on average for the first two months of 2019. Growth in fixed investment slowed to 6.1% relative to a year ago, as weak growth in infrastructure spend, slowed to below 5%. Mitigating this is the fact that the composition of growth is shifting in China, with consumption and services expected to drive the economic expansion as investment and export growth are expected to decline. Chinese retails sales growth remained solid at an average of 8.2% for the first two months of 2019, while the consumer confidence index remains at an all-time high of 123 index points. This compares to its long-term average since 1996 of 109, largely due to robust growth in real disposable income and the expectation of promised tax cuts.

Local Market Overview

The JSE All Share Index (ALSI) has enjoyed a strong start to the year, with gains recorded in each month of the first quarter. The positive start to the year has seen the ALSI follow most international indices higher, as risk-on trade has returned to the market, largely on the back of the US Federal Reserve's dovish statements towards the end of January. By the end of the first quarter, the ALSI managed to gain 7.97%, reversing most of the decline experienced in 2018.

The South African Reserve Bank left interest rates unchanged in both January and March, keeping the repo rate at 6.75%. Consumer inflation figures for February registered an increase of 4.1%, in line with expectations.

GDP figures released for 2018, came in higher than expected as the South African economy grew by 1.10% compared to the 0.6% expected.

On the final trading day of the quarter, Moody's was expected to deliver an announcement on South Africa's sovereign credit rating, however, the rating agency deferred its review. South Africa's credit rating, therefore, remains unchanged at Baa3, one notch above junk status.

Resources

The Resources Index was the top performer on the JSE in the first quarter of 2019, climbing 16.18% over the period. Platinum counters kept pushing higher, with Impala Platinum gaining 66.30%, Northam Platinum rising 46.79% and Anglo American Platinum adding 38.25%. This has been driven mainly by a structural deficit in the PGM basket, with platinum trading at approximately USD850.00, an increase of almost 7% over the quarter.

Iron ore was another strong performer, with the price rising 14.91% in USD, helping push Kumba Iron Ore's price up nearly 60%.

The Bloomberg Commodity Index grew by 6.32% in USD, showing supportive pricing for a basket of commodities, while the dollar exchange rate has had little impact, with the dollar appreciating a marginal 1.08%.

Industrials

After a disappointing 2018, the INDI25 index rebounded in the first quarter of 2019, propelled largely by the rand hedge shares pushing the INDI25 8.80% higher. Some of the large players that performed so poorly in 2018, recovered some of those losses, with the likes of British American Tobacco (+27.4%), AB Inbev (+26.7%), Naspers (+15.2%), Bid Corp (+12.45%) and Richemont (+11.8%), bouncing back in the quarter.

Certain companies exposed to the local consumer came under significant pressure, however, as consumer discretionary spend remains constrained in an environment of low growth, high unemployment, and higher interest rates, VAT and fuel prices. Mr Price (-23%), Truworths (-21.2%), Shoprite (-16.6%) and Woolies (-15.6%) were the worst performing retailers. Even the likes of Vodacom (-15.6%) are feeling the pressure from a constrained consumer, with a poor trading update sending the share price tumbling.

The Aspen share price (-31%) was hammered again, as the Group released their interim results that sent investors fleeing. The pharmaceutical company is suffering from low/flat top-line growth, poor cash conversion and an over-leveraged balance sheet - a toxic combination.

Financials

After a very strong start in January, the FINI15 performed poorly for the rest of the quarter, declining in both February and March, to end the first three months -0.44% lower.

A mixed performance from the banks saw Nedbank, Absa and FirstRand end in negative territory, while Investec, Standard Bank and Capitec ended in the green. Capitec was the outlier, managing to add 20.75% during the quarter. Discovery was the worst performing insurer, falling 14.4%, while Sanlam fell 7.6% and Old Mutual was 2.4% softer.

Both banks and insurers, who are sensitive to the health of the economy and consumer, have found the going tough in such a weak economic environment. Property companies NEPI Rockcastle and Growthpoint both ended the quarter in the green, while Redefine Properties finished flat.

Listed property

The local listed property sector continued its decline during the month of March, as foreign selling accelerated across the board. An overall decline in stock prices was experienced regardless whether the counter had a local or offshore bias. The listed property index was down 1.46% for the month of March.

Property fundamentals remain weak in a low-growth environment. Event risk, such as the fear of a ratings downgrade and political tensions ahead of the May elections, have also increased volatility. The office sector remains a laggard as oversupply increases. The near-term outlook remains volatile in a challenging sector.

We maintain a diversified mix of property counters in our portfolios. The investment strategy remains focussed in shares that fall within defined quality and liquidity parameters.

Local currency

The South African rand remained volatile over the quarter, with continued load-shedding by Eskom adding pressure to an already strained economy. The rand traded in a range between ZAR14.60/USD1 to ZAR13.25/USD1, edging higher towards the end of the period prior to the Moody's sovereign rating outlook announcement.

Economists were largely split in their view as to whether a downgrade would take place, with Moody's opting to retain their current stance on South Africa's sovereign rating. Despite no finality on the Brexit deal in the United Kingdom, sterling gained traction against the rand, appreciating 3.13% over the quarter and ending at a rate of ZAR18.89/GBP1. The euro depreciated marginally against the rand in the first quarter, closing trade at ZAR16.27/EUR1 by the end of March, down 1.13%.

Local Fixed Income

Market Review

Global bond yields moved lower during the month of March on the back of weaker global growth concerns. The 10-year generic US bond yield was down 31 basis points, to 2.41%, as the curve inverted. The German 10-year generic followed suit and was down 25 basis points to end the period at -0.07%. The French long-bond yield also declined by some 25 basis points to end the month at 0.32%.

Yield movement in the local bond market was characterised by event risk, such as intermittent electricity blackouts, the SARB holding rates steady and the inaction of the ratings agency, Moody's. Despite continual foreign selling, the JSE All Bond total return index was up 1.28% for the month.

Inflation-linked bonds lost ground, as real yields climbed higher, fuelled by a larger-than-expected increase in the weekly auction size.

Our fixed income outlook for the coming month is detailed as follows:

- Economic growth remains low, with little signs of substantive recovery.
- Currency volatility will continue to be fueled by political and international factors.
- Electricity tariff increases, and potentially higher oil prices remain threats to the economy and inflation.
- Foreign flows are negative, and the economy remains vulnerable to event risk factors such as the imminent general elections.
- Short- and long-term technical trends have turned positive for now.
- Local sentiment remains cautious.

We continue to seek value along with yield curve with careful duration risk positioning of our portfolios.