M&G Investments

M&G Insights

Local assets still more attractive than offshore

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Despite the challenging year 2023 has proved to be so far in South Africa, in our view local assets are still clearly offering better prospective returns for the risks involved over the next three to five years than their global counterparts. This means that at M&G Investments our multi-asset portfolios like the M&G Balanced and Inflation Plus Funds favour South African equities and bonds, although select global equities and bonds are also attractive, and offshore assets play critical roles as diversifiers to achieve the best possible risk/return balance for our clients.

Global equities vs SA equities

One of the most compelling reasons for our positioning is the differential between the valuations of global and South African equities. In aggregate, global equities are trading slightly cheaply compared to their long-run equilibrium or fair value, which is reflecting the cheapness of many global equity markets offset by the relative expensiveness of the US market, which, with a 12-month forward P/E ratio at 19.4X, has pushed the MSCI ACWI P/E ratio to 16.2X as of mid-August.

Because there are still unresolved questions around downside risks to global earnings going forward, including inflation and growth, we are neutrally positioned in global equities and remain selective: we continue to be underweight US equities, as well as Canada and Australia. We prefer the UK, Japan, China and certain other emerging markets that are relatively cheap.

Meanwhile, the SA equity market's valuation (12-month forward P/E ratio of the FTSE/JSE Capped SWIX Index) was trading at 10.6X, broadly reflecting depressed earnings expectations and low share prices. However, we believe this presents real opportunities for careful investors. Our analysis shows that current market pricing is implying SA equities have a prospective real return of 8.9% p.a. over the next five years, compared to global equities at 5.9% p.a. and US equities at under 5.0% p.a.. This is well above the local equity market's long-term fair value of around 7.0% p.a..

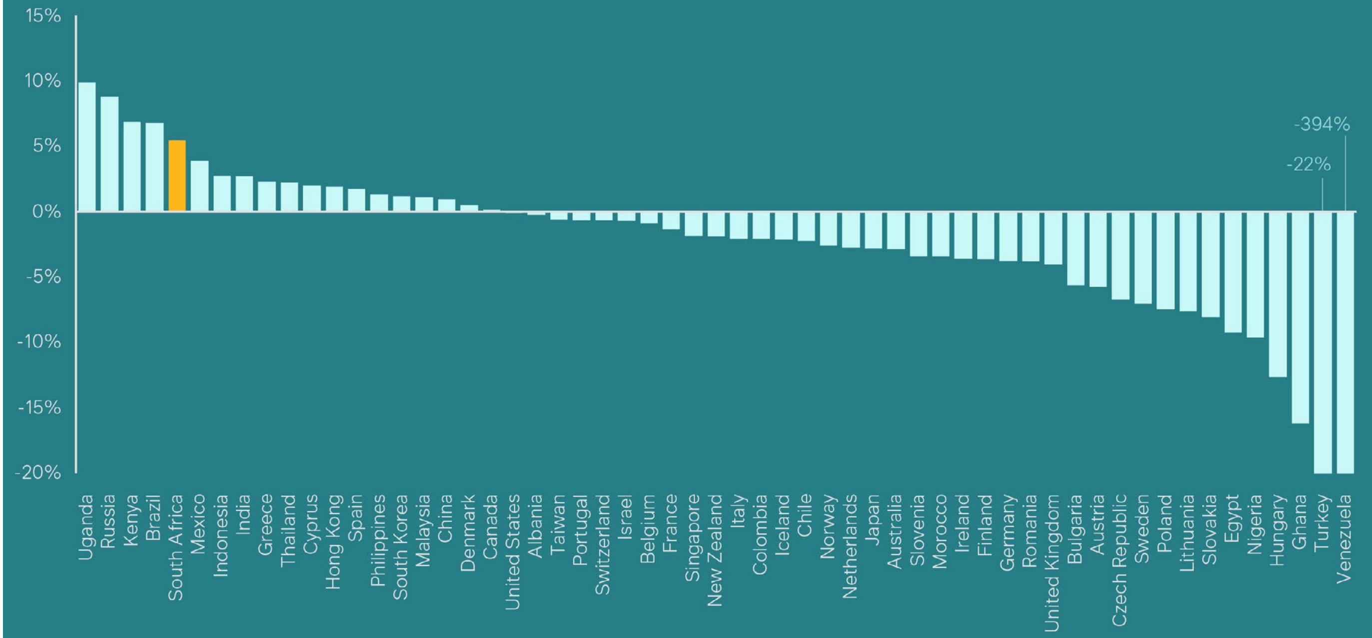
Our portfolios include a well-considered mix of rand-hedge, "SA Inc", defensive and attractive shares, with some of our preferred shares being BAT, Richemont, MTN, Textainer, Glencore, Reinet, Naspers/Prosus, and a collective overweight exposure to SA banks like Standard Bank, Absa and Investec.

Global bonds vs SA bonds

A look at Graph 1 shows how the real yield on South Africa's 10-year government bonds, at well over 5%, is far more attractive than that of 10-year US Treasuries at just over 1%. In fact, SA real bond yields are more attractive than those of most other countries and are elevated relative to their history. As market valuations currently stand, our analysis shows that SA nominal bonds have a prospective real return of 6.4% p.a. over the next five years, compared to global bonds at 1.2% p.a..

Graph 1: 10-year bond yield minus current inflation

Inflation + 5% is hard to come by



Source: Datastream, M&G Investments 10.07.2023

While we acknowledge that investor risks are more elevated than they were at the start of the year, they are certainly not higher than during the GFC or Covid. Current yields are pricing in a very unlikely scenario of local inflation remaining well above the SA Reserve Bank's 3-6% target range indefinitely – despite June CPI having already fallen back to 5.4% y/y and the SARB's strong track record combatting inflation. At the same time, South Africa has a favourable history of repaying its debt, and is not on the brink of defaulting. In our view, current yields will more than compensate investors for their associated risks, and patient investors will be well rewarded.

Looking ahead, there are some factors that can provide tailwinds for SA equities and bonds, including falling inflation, a shift to expansionary monetary policy/interest rate cuts both globally and locally, private sector contributions to new sources of power supply and improving infrastructure, and the government's acknowledgement of the urgent need to improve its service delivery.

Current sentiment may favour the seemingly "safer" global options, but in these conditions our long-proven investment process indicates that the "safest" way to deliver excellent returns is to remain overweight in cheaper South African assets, while maintaining our neutral positioning in global assets primarily for their diversification benefits.