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Taking Advantage of Market Volatility to Produce Superior Risk-Adjusted Returns

Richard Harris | November 2024

The year 2024 was characterized by several significant changes in the global financial landscape, with numerous events taking center stage throughout the year. Central banks around the world began to loosen monetary policy and cut interest rates to stimulate economies. A global election Supercycle saw more than 54% of the world's population participating in key elections, while tensions in the Middle East and between Russia and Ukraine increased dramatically.

The year was also marked by severe weather events, ongoing developments in artificial intelligence and economic inequality and weakness, particularly in China and some parts of Europe. With the expansion of the BRICS group and tougher treatment of these countries by the West, there were geopolitical realignments and a shift in global alliances. The presidential elections in the US ultimately led to Donald Trump and the Republican Party winning a clear victory in the House of Representatives and the Senate, further shaping the global political landscape.

As the world has evolved before us, many opportunities have arisen to change the composition of portfolios locally and abroad. Although the United States continues to dominate the investment environment, there have been several changes to the status quo that we believe present exciting opportunities to generate risk-adjusted returns over the coming years.

Given the recent volatility in local and international markets, and the Rand, we thought it made sense to end the year with an update on our portfolio positioning developments and how we plan to take advantage of them to maximise risk-adjusted returns for our clients in 2025 and beyond.

Following the clean sweep Republican victory in the United States, US markets have risen notably. The recent surge can be attributed to Trump's pro-business stance, characterized by promises of tax cuts and deregulation, leading investors to expect an upturn in

economic growth and rising corporate profits. The financial sector saw significant gains on expectations of relaxed regulatory measures, while the cryptocurrency market boomed, with Bitcoin reaching new highs of over USD 100,000, fuelled by Trump's shift to support cryptocurrencies. Companies aligned with Trump's vision, such as Tesla, have also seen their stock prices soar.

Emerging markets have primarily been the funders of this recent upswing in the US and have therefore significantly underperformed over the past two months.

Despite this euphoria, it is important to note that US markets were already "richly valued" compared to foreign markets and underlying concerns remain, especially when considering US debt levels. In order to fund said tax cuts, government borrowing will need to be significantly increased (or spending reduced), which may result in higher borrowing costs for businesses and individuals. As a result, US government bonds have been sold aggressively and bond yields have risen: The yield on ten- year US government bonds rose from 3.75% to 4.5% within six weeks.

Trump’s intention to move manufacturing to the US and the imposition of harsh tariffs on trading partners (especially those close to the BRICS countries) create further potential headwinds for borrowing costs in the US and globally, challenging the feared resurgence of inflation as cheap exports from China, which have contributed to global deflation, are one of the biggest threats to onshoring in the US.

We remain cautious in our global economic outlook, especially when looking for investment opportunities in the US. There are many US sectors that are fairly valued, but at the index level, concentration has become a major risk to future returns as mega-cap technology companies have taken centre stage and now make up a large portion of the S&P 500, arguably the most followed index globally. Due to recent capital flows into the US and the resulting appreciation of the dollar, the rand weakened from R17.05/$ to a recent high of R18.40/$, creating an opportunity to bring dollars back into rands, and capitalise on the potential tailwinds that are likely to exist in South Africa post-elections.

Our clients have benefited greatly from our aggressive stance to maximise offshore exposure over the past decade, as this positioning has been a great hedge against a weakening local economy and the resulting outflow of foreign investment.

We recently decided to change our stance from underweight the Rand to neutral and as a result have used the rand's recent weakness to repatriate a small portion of our offshore dollar exposure as we believe the rand and local markets should outperform in the coming year and beyond. Our reasoning is based on the following:

- **A weaker US dollar –** as the recent euphoria fades and US policymakers need to cut interest rates more aggressively to stimulate the economy. In addition, emerging markets tend to perform better in rate cut cycles.
- **Improving economic fundamentals –** increasing political stability and economic growth (from a low base) will benefit the South African investment horizon and hence the Rand. Further tailwinds from a stable power supply and infrastructure will also benefit local investments.
- **Foreign investment –** for obvious reasons, foreign investment in South Africa has declined significantly in the equity and bond markets over the past decade. Improvements to the economy through the newly formed GNU could lead to foreign inflows again, which will have a positive impact on equity and bond valuations
- **Interest rate differential –** the SARB has made it clear that its mandate is to lower inflation, and this is likely to lead to slower rate cuts domestically than overseas,

increasing the attractiveness of the carry trade and benefiting the rand.

- In terms of **purchasing power parity (PPP),** the rand is currently at an extreme level. Economists believe that the rand should be at R15/16 to the dollar based on this measure and Goldman Sachs forecasts that it will reach R14 by 2026.

Although the above points paint a rosy picture of the local economy, we are aware of the associated risks, which is why we are not overweighting our view on the local economy but taking a neutral stance instead as developments locally take shape.

Introduction of Local Hedge funds

I am sure that most of you reading this newsletter are knowledgeable of the names of local hedge fund managers, particularly 36One and Peregrine Capital who have been able to achieve equity-like returns with extremely low volatility over the past 2 decades. Established Hedge fund managers have vast teams of sophisticated managers and are designed to pursue higher returns through dynamic strategies and active management, often outpacing traditional investment options.

One of their key strengths is diversification, as hedge funds typically spread their investments across different assets and utilise tactics that do not always move in lockstep with traditional markets. This diversification can help buffer an investor's portfolio against market fluctuations.

We have been monitoring hedge funds for inclusion in our portfolios for a number of years and believe that, given our current cautious stance on global markets and economies, should provide our clients with the best exposure to local markets while limiting risks should the economic situation in the US deteriorate, which in turn will have knock-on effects on local markets. For example, the 36One Retail Hedge Fund recorded a decline of 6.5% in 2020, while the general South African equity index lost more than 20%.

We have allocated funds to the 36One Retail Hedge Fund in our non-Reg 28 compliant portfolios and four hedge fund managers in our Reg 28 compliant models in accordance with the rules set out for these mandates. These include 36One and Peregrine for the equity component and the Amplify SCI Diversified Income and Amplify SCI Income Plus hedge funds for the fixed income component. These fixed income funds are managed by Matrix Fund Managers and Terebinth Capital respectively, both of which have a long-term track record of superior risk-adjusted returns.

It is likely that 2025 will be an action-packed year after Trump's inauguration on 20 January. While there are many other themes also shaping the global landscape, clarity in foreign policy, led by the United States, is likely to set the roadmap for the global environment in the coming years. What will also need to be watched closely is any retaliation from global partners who disagree with US policy and how this will affect foreign relations.

We look forward to keeping you informed of all new developments in this ever-changing macroeconomic environment and wish our clients a joyous holiday season and a prosperous 2025.

Market Update

Market performance in November was primarily attributable to the US election results which saw US markets continue their outperformance as investor confidence in the region

reacted to Trump’s pro-business stance. Returns in US sectors were more broad-based with the Dow Jones, S&P 500 and Nasdaq 100 up 7.7%, 5.9% and 5.3% respectively.

Inflation data for October was mostly in line with expectations with an expected increase in the Consumer Price Index and Personal Consumption Expenditure Price Index, however the Producer Price Index surprised higher to the upside than expected. The Fed's disinflationary progress may be slowing more than expected as it nears its target. As a result, the Fed decided to cut rates by only 25 basis points and issued cautionary commentary indicating a gradual cutting cycle ahead.

Stickier than expected inflation, concerns around debt levels and possibly inflationary tariff policies buoyed the yield on the US 10 year initially to 4.5% where it subsided to end the month around 4.2% following the announcements of key positions reassured markets of a disciplined fiscal policy and improved reforms. The above led to further dollar appreciation with the dollar Index rising 1.7% compared to its peers.

Emerging markets and currencies bore the brunt of this shift in capital and investor concerns of likely tariffs to be imposed by the US. The MSCI Emerging Markets index ended the month down 3.6%.

On the commodity front, oil prices fell 0.3% as talks over a ceasefire between Israel and Hezbollah ramped up but remained stable as the tug-of-war between Trump’s promise to increase oil supply and rising tensions between Russia and Ukraine caused short-term uncertainty in the energy sector. Gas prices rose by more than 20% over the month following a sharp drop in supply and the onset of cold weather in parts of the world. The gold price consolidated after a period of strength and fell by 3.3%.

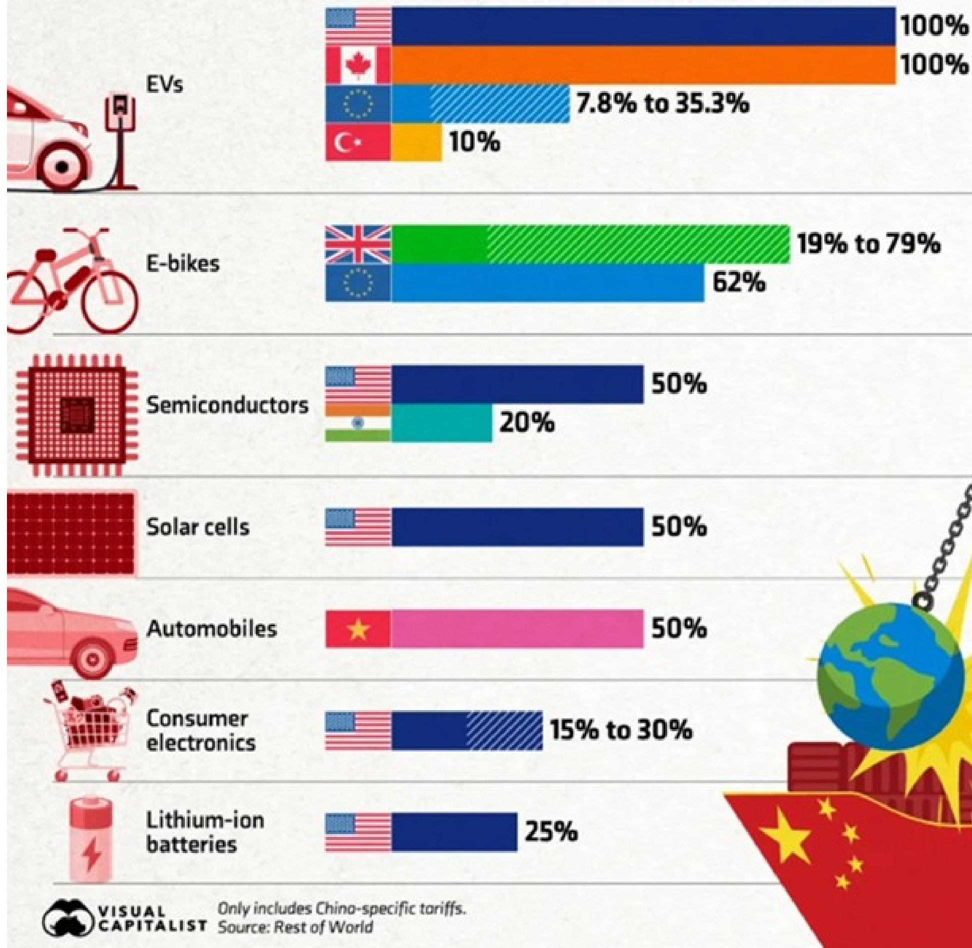
Locally, South Africa’s credit rating was upgraded to "positive" by S&P and a retained of "stable" by Fitch. This helped to reduce the rand's losses and resulted in the local currency depreciating by 2.8% against the dollar to finish the month at 18.10/$.

Headline inflation for the year to October 2024 fell from 3.8% in the previous month to 2.8, trending below the SARB’s target range of 3–6%. Similarly, producer price inflation for October came in at -0.7% from a figure of 1.0% in the previous month. The South African Reserve Bank (SARB) lowered the lending rate by 25 basis points, which was in line with expectations. The equity market fell over the course of the month, with the JSE All Share Index recording a decline of 0.9%. The Resources sector was the main contributor with a negative return of -6.7%, while industrials (0.0%) and financials (0.3%) remained largely unchanged over the month. Small caps (3.6%) outperformed large and mid-caps.

Our market outlook, both locally and abroad, remains cautious as we continue to monitor ongoing global developments and central bank commentary. Despite recent adjustments to our portfolios, we remain defensively positioned, with sufficient offshore exposure and relatively high cash and defensive allocations in our portfolios. In the near term, we will seek to invest in assets that generate higher returns (alpha) and offer reasonable risk-adjusted returns at favourable entry points.

Chart of the month

The following chart shows global tariffs imposed on Chinese technology exports due to their ability to produce at low cost, impacting local manufacturing. These tariffs are expected to rise under Trump's leadership, which could have adverse effects on global inflation in the near future. It is also somewhat contradictory that many Western countries have recently pledged to switch to green energy alternatives but are now imposing higher tariffs on these alternatives exported from China.



"Volatility is the price of admission. The prize inside is superior long-term returns."
David Rolfe

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Our mailing address is:
Absolut Wealth Management
1st Floor, North East Block
5 Wessels Road

Rivonia, Gp 2128
South Africa

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