M1 CAPITAL
INVESTMENT MANAGEMENT

Declining Inflation and Durability in the Stock Market – Market Commentary

The year ended with negative returns across most markets. The JSE strongly outperformed both Emerging Markets and Developed markets mostly through good bank performance as well as Naspers (which outperformed Prosus by just over 24%), and other select stocks.

Internationally, Emerging Markets were marginally below Developed Markets. The well-known and well-worn theme of Value vs Growth developed courtesy of rising interest rates i.e. Value outperformed Growth, although both were down. Value outperformed the aggregate MSCI World Index substantially as well. As a result of similar forces the Nasdaq also steeply underperformed the S&P 500.

These various global returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for December 2022 *

	Dec-22	YTD 2022
FTSE/JSE ALSI (ZAR)	-2.3%	3.6%
FTSE/JSE ALSI (USD)	-2.4%	-2.8%
MSCI World	-4.2%	-18.1%
MSCI EM	-1.4%	-20.1%
MSCI Value	-2.5%	-6.5%
MSCI Growth	-6.1%	-29.2%
S&P 500	-5.8%	-18.5%
Nasdaq 100	-9.0%	-32.4%

*Total return indices, Source: Factset

At the time of writing global markets have kicked off the new year in style with the Nasdaq notching an +11.5% return. We note that from a technical perspective it appears the market has been in a channel for some months, and though the new year-to-date return appears strong, so far this appears to be merely a retracement of previous negative returns within the channel. The most recent movements are set out in Chart 1 below.

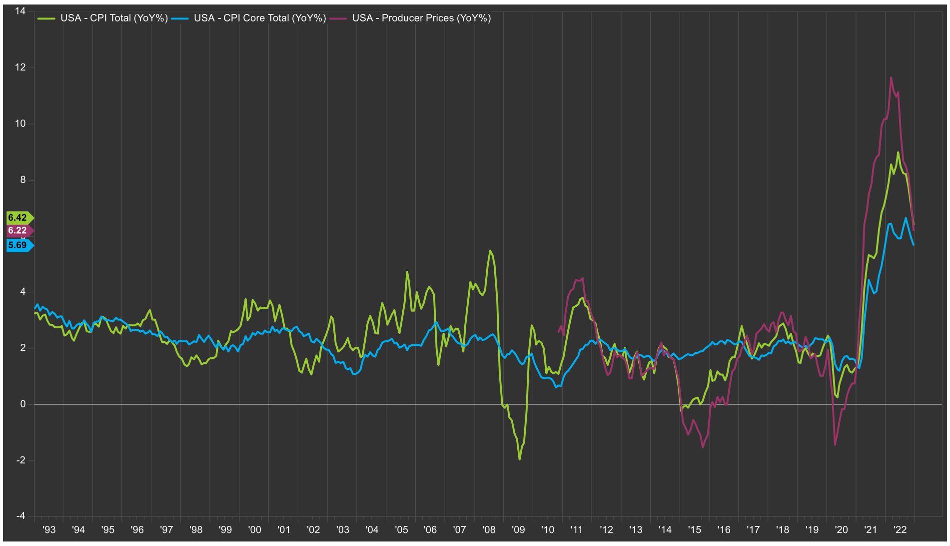
Chart 1. Recent performance of the Nasdaq

Source: Factset

Effectively it seems that the market has paused its declines, waiting for assurance on the direction of inflation since this will determine the likely path of interest rates. The other unknown is the direction of earnings given a widely-expected slowdown.

For our part we have commented several times through the course of the year that inflation is likely to decline. Since this now appears to be materialising, we warn the declines are likely to take longer, and not necessarily in a straight line, than perhaps recent market movements suggest. The steepest inflation declines to date have taken place in the Energy sector with the oil price falling 30%. CPI and PPI therefore appear to be declining steeply. In contrast, Core CPI (ex-Food and Energy) appears to be stable to declining mildly. In much the same way as oil price increases feed into goods through input costs, so price declines can be expected to have a moderating impact across the economy. The various inflation indices are set out in Chart 2 below.

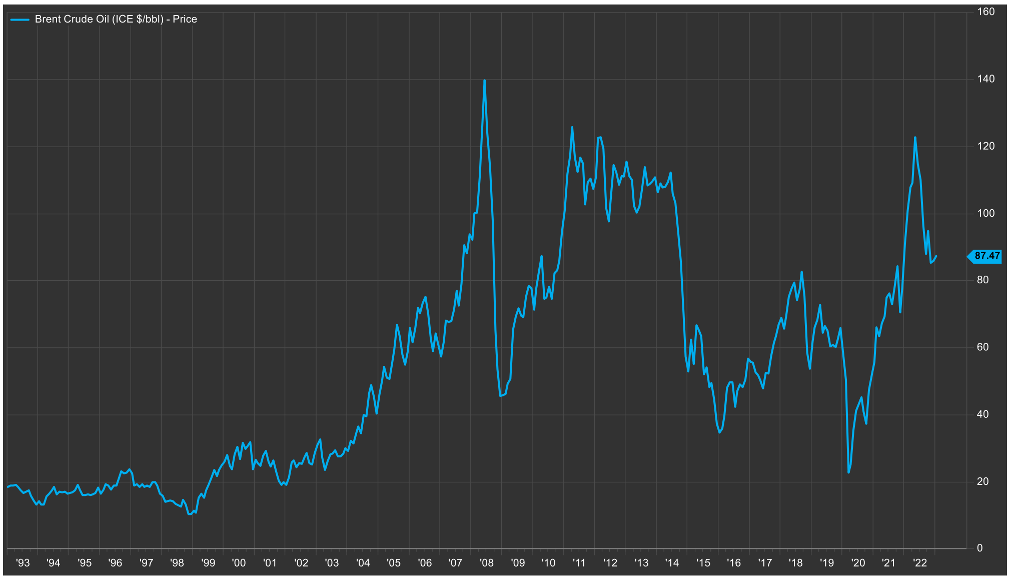
Chart 2. Inflation indices to December 2022



Source: Factset

CPI's dependence on oil however carries risks. China's reopening will likely be supportive of oil prices, and, as if a reminder is required, there is a military conflict still raging involving a major producer accounting for 15% of the market. Further, there are widespread expectations of a slowdown. Should these change e.g. a recession does not, in fact, materialise as expected, and should the oil price rise, this will prove supportive of inflation. Core CPI remains important, and this has not declined materially yet.

Chart 3. Oil price



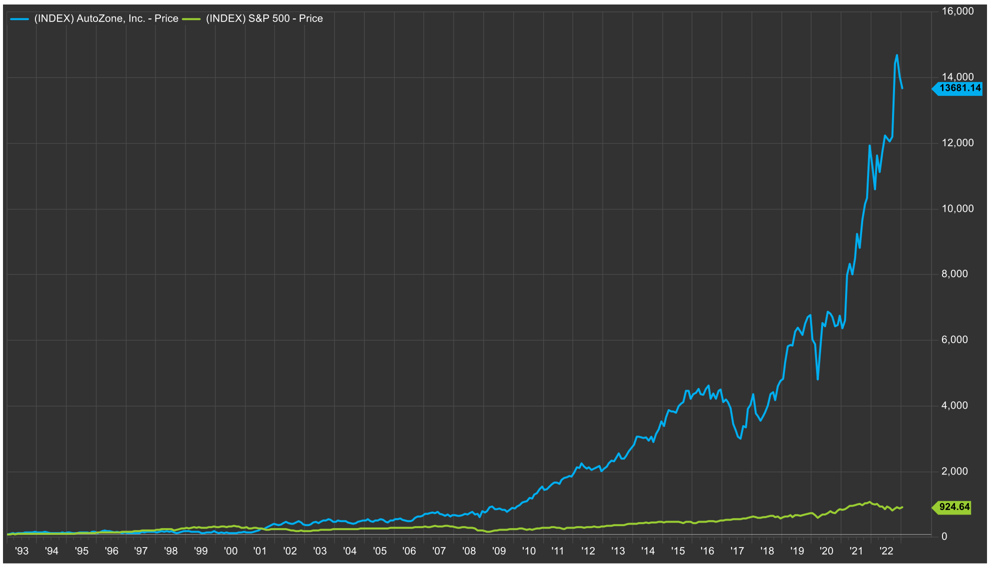
Source: Factset

Are Value stocks the only ones that outperformed?

As a second part to this commentary we note that two of the investment themes for 2022 were the outperformance of Oil and the outperformance of Value shares (The two are not independent of course – since Oil shares tend to not be in the Growth index, they end up in the Value index by default). We present here an alternative.

Exxon returned +80.3% in 2022. Autozone, a US car parts and accessories retailer, returned +17.6%, far lower than Exxon for the year, but nevertheless still beating the MSCI World Index by 35%. Importantly, over the last 3 years Autozone returned +76.0% against the MSCI World's +36.8% and Exxon's -12.3%. Perhaps more impressively, over the last 30 years Autozone has returned more than 136x, compared to the S&P 500's 9x (excluded dividends).

Chart 4. Autozone long term performance relative to the S&P 500



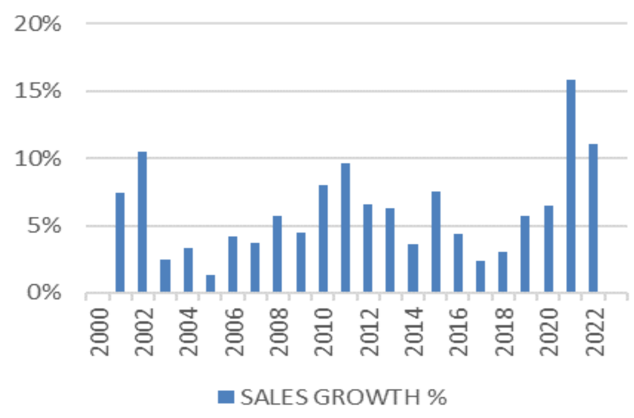
Source: Factset

Are car parts that exciting? From a stock price point of view it would appear so. We note on the above chart that after suffering a -29% decline between December 2019 and March 2020, Autozone's stock price went on to return 3x or 200% over the next 3 years. It would appear that it pays to hold on to good assets through volatility.

Autozone was listed in 1991 with its primary business in the US. Current areas of expansion are Brasil and Mexico and the company operates stores in three formats – satellites, hubs, and mega hubs – and also offers repair services.

What's to like about the company? Quite a lot, we think. Underlying the stock price is consistent revenue growth – the company has not experienced a decline in revenue in the last 20 years including during recessions e.g. in 2008. The most recent recession was rather unique too. Car part prices rose strongly not only due to the chip, and car, shortage in the US, but also because of rising input costs. This translated into the strongest top line growth the company has experienced since 2000. So the company has had a very good pandemic.

Chart 5. Autozone revenue growth



Source: Factset

It has also maintained margins while producing consistently high returns on capital, and steadily rising cash flow, part of which has been used to reduce issued shares by 5 -10% every year.

Are there any threats on the horizon? An immediate expectation would be a normalisation in supply chain disruptions and declining inflation – by default revenue growth should moderate from a high base. A more medium term consideration would also be the emergence of electric vehicles which do not have conventional engines and would likely require some adjustments both to Autozone's business model and inventory.

Finally we note in this brief review that while Autozone has performed exceptionally well, this performance is not company-specific but rather attributable to the sector. O'Reilly Automotive, a competitor, has produced yet better stock price performance with similar operating characteristics.

The M1 Capital Global Equity Prescient Fund has held both Autozone and O'Reilly Automotive since inception in 2016, though this was not enough to counter the Value/Growth theme of 2022.