M1 CAPITAL
INVESTMENT MANAGEMENT

Ramaphoria II – Market Commentary

May's South Africa performance has quickly been superseded by the election results and market movements in June, covered in more detail below. We nevertheless first briefly review South African and various global market returns.

The month was little-changed for South Africa in terms of recent trends. There was effectively no currency movement therefore ZAR returns translated almost directly into USD returns. The JSE was in line with Emerging Markets at +1.0% vs +0.6%, with both underperforming Developed Markets by a reasonably wide margin.

Developed Markets represented by the MSCI World Index returned +4.5%. This was driven primarily by the US and primarily by the big Tech companies where Nvidia, Alphabet et al turned in another strong performance. The Nasdaq outperformed the S&P 500 with +6.4% vs 4.9%, and Growth outperformed Value by +5.7% vs +3.2%.

The various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for May 2024*

	May-24	YTD 2024
FTSE/JSE ALSI (ZAR)	1.0%	1.6%
FTSE/JSE ALSI (USD)	1.0%	-1.3%
MSCI World	4.5%	9.5%
MSCI EM	0.6%	3.4%
MSCI Value	3.2%	7.1%
MSCI Growth	5.7%	11.8%
S&P 500	4.9%	11.1%
Nasdaq 100	6.4%	10.5%

*Total return indices, Source: Factset

The local market news of the hour is undoubtedly the movement on June 18, post-public holiday and post-news of the prospect of a Government of National Unity (GNU). The JSE rose by +3.5% on the day, driven by the so-called SA Inc shares.

Value managers have for some time been pronouncing on the relative cheapness of stocks with local exposure, something we agree with on a case-by-case basis. On the day however the buying appeared indiscriminate – Capitec, Clicks and Shoprite were some of the best performers returning +9.1%, +8.9% and +8.0% respectively, yet these are hardly the cheapest stocks at PE multiples of 28x, 30x and 25x. We happen to hold Clicks and Shoprite, however the reasons for holding them is a matter of separate commentary.

Several fund managers have also taken to the media and social media channels to pronounce a turning point in SA history and markets. We are not so sure. We proceed here with our interpretation, and, as usual, attempt to present some different arguments as to what the future might hold for markets. This commentary is in fact more about economics than politics.

Ramaphoria II

The episode was evocative of Ramaphoria, already experienced in 2017. The market appears very quick to rally on hope, only to see the gains peter out when hard economic realities set in. This is not to say hope is not justified this time (we certainly hope it is). To date, however, the track record of coalitions at local government level is not good –

anecdotal evidence suggests true decline began with the onset of unstable coalition governments – a sub-par manager appears to have been better than effectively no manager at all. And the recent rally seemed to be built on nothing more than the prospect of the DA, the (possible) junior partner, entering government.

Economics trumps politics

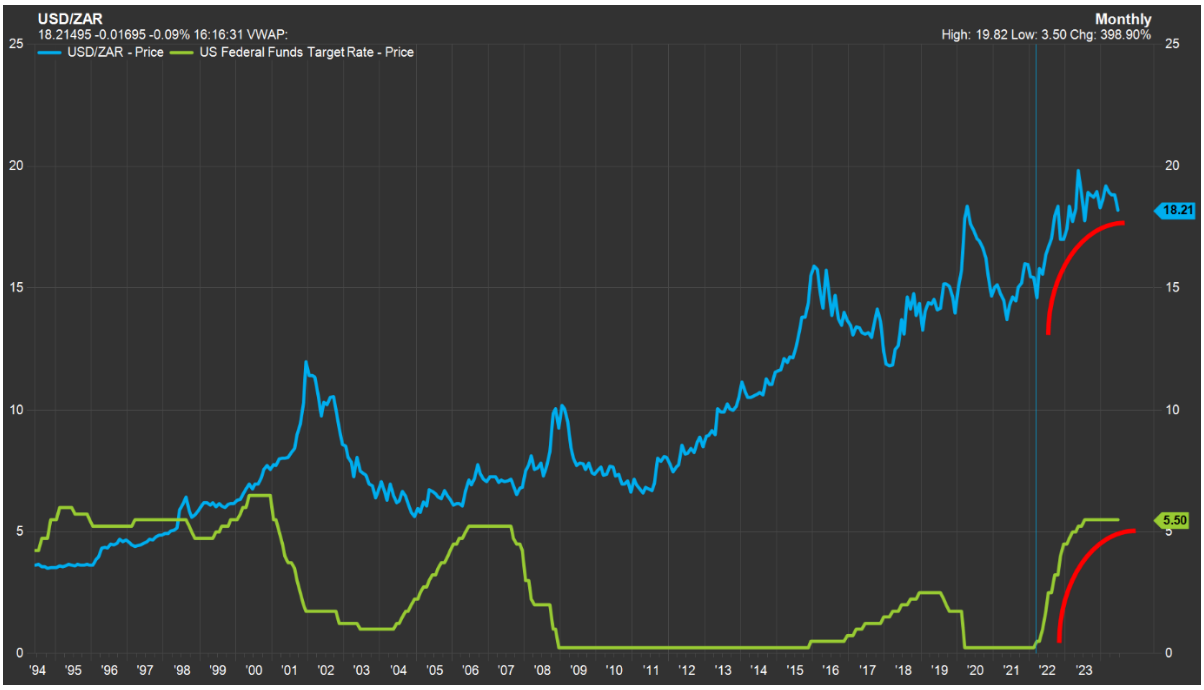
The expectation is of course that better government will lead to better economic performance and better underlying company performance. The political and economic road implied by this line of thought is long and uncertain – the GNU could unravel tomorrow, for example. Instead, we make suggestions as to current economic circumstances and what they might mean for markets going forward.

What happens to the exchange rate?

The USDZAR strengthened by +1.5% on the day, also prompting commentators to forecast further strength. We also think currency strength is a likely prospect, but not for political reasons.

Chart 1 below presents the USDZAR rate vs the US Fed Funds Target Rate.

Chart 1. USDZAR vs the US Fed Fund Target Rate



Source: Factset

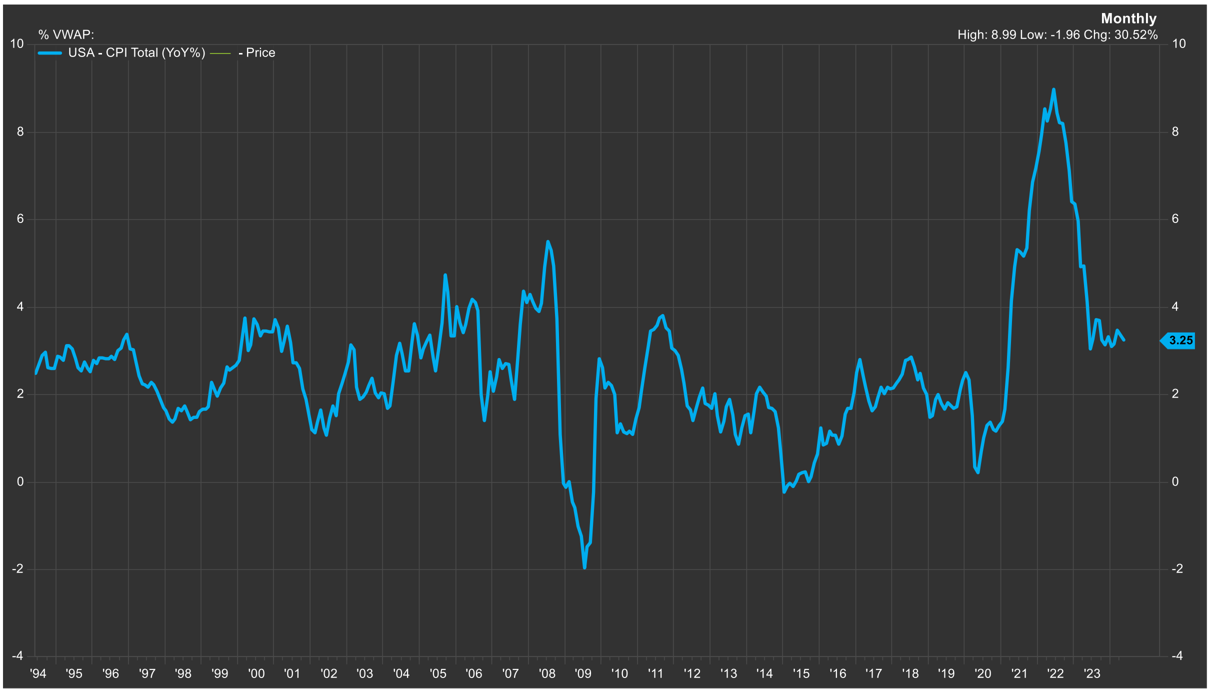
Per Chart 1 above we suggest that the current bout of ZAR weakness is almost entirely due to the rising Fed Funds rate. The weakness appears to have begun when the US interest rate began to rise, to the day.

What does this mean for the future USDZAR rate? if we assume the Fed hiking cycle is complete and the next move is down then we would expect ZAR strength.

Some uncertainties could complicate this picture

1. Chart 2 below sets out US CPI year-on-year percentage growth

Chart 2. US CPI year-on-year percentage growth



Source: Factset

Per Chart 2 above, the CPI number appears stuck close to 3.25% since last June, while the target remains 2%. An FOMC member has already commented that the Fed rate could yet rise further if no progress is made on inflation. Admittedly the Fed follows the PCE gauge but should the US interest rate rise again we are back to a depreciating USDZAR, falling markets and Value outperforming Growth

2. Should an economic downturn arise in the US, a prospect, we think, with increased likelihood, we could again fully expect sharp ZAR weakness

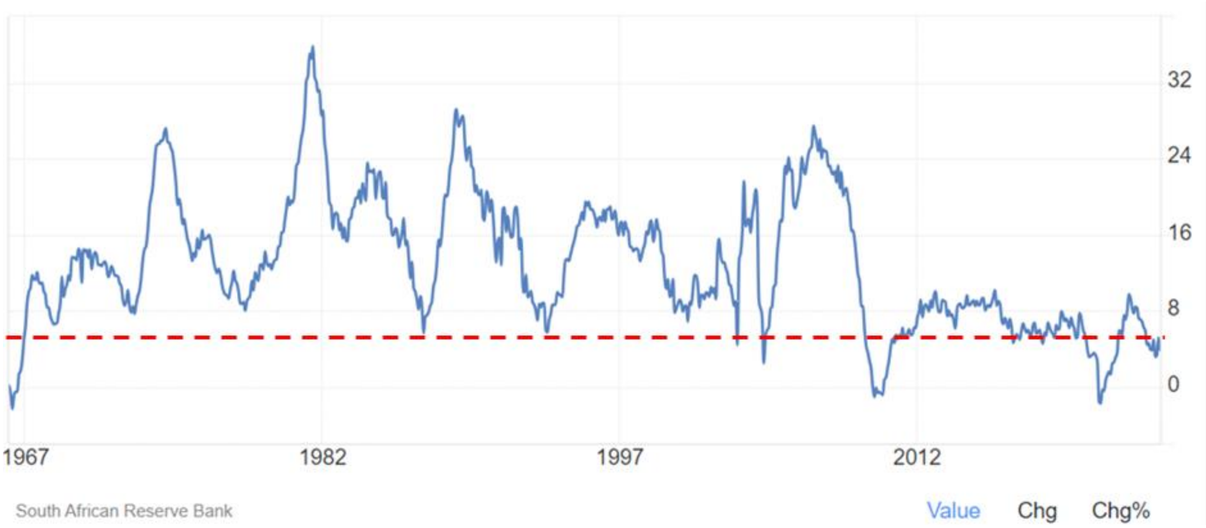
SA economic growth

A second aspect is one we have commented on in the past. Up to 90% of money in circulation is credit-based. In this sense credit is the life blood of the economy and bank lending is an indicator of the level of activity and spending. Chart 3 below shows bank lending stuck at recessionary levels since 2008 – effectively indicating a never-ending recession, irrespective of the standard economic rules i.e. 2 quarters of negative growth as a definition of recession.

We do not doubt that government inefficiency and rent-seeking in an economy (corruption) have been serious impediments to economic growth. These do not however explain the consistency of pattern seen in Chart 3.

Politics and government mismanagement are easy to see and therefore easy to criticise. These are undoubtedly part of the picture. Per previous commentary we suggest that a different fundamental underlying driver of the economy is the level of debt. This is less readily apparent and something the media writes little about, but at the same time a real financial constraint.

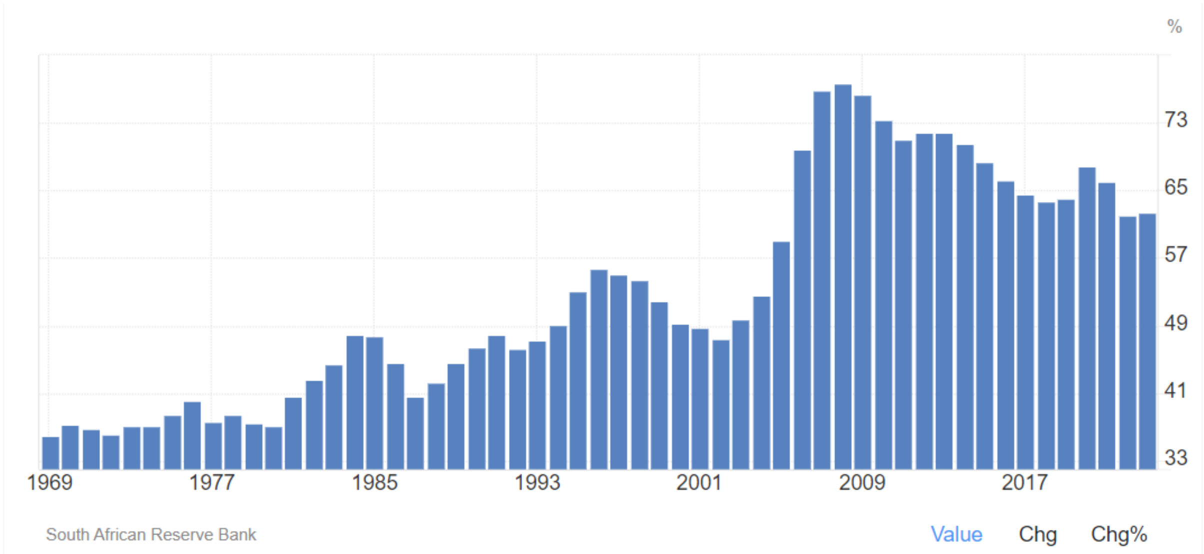
Chart 3. South Africa private sector credit extension annual percentage change



Source: SARB / www.tradingeconomics.com

Chart 4 below represents the level of indebtedness of households. We believe this to be one of the most important charts in SA macroeconomics which explains economic performance since the financial crisis.

Chart 4. South Africa household debt to income



Source: SARB / www.tradingeconomics.com

The buildup in leverage up to 2008 is clear. Thereafter a multi-year period of deleveraging set in which, we believe, better explains the low economic growth rate, and the associated anaemic level of lending in the economy. Debt repayment necessarily diverts funds from spending and depresses credit demand.

We are not able to suggest what a sustainable level of debt to income is except to note it is currently still above the previous peak and likely still too high. While hypothetical and uncertain future economic policies might make a difference we believe this to be a true underlying force driving (the lack of) growth.

Summary

As usual the macro outlook is complicated and uncertain. We suggest however that far from a likely unstable GNU, currency strength and persistent weak economic growth are likely to prevail due to US Fed policy and continued high levels of debt in the SA economy.

As for Ramaphoria II, we would not be surprised if this subsides, much like Ramaphoria I, particularly as many suddenly high-flying SA Inc companies report their latest financial results.