

Prosperity

January 2024

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Private Clients
by  Old Mutual Wealth

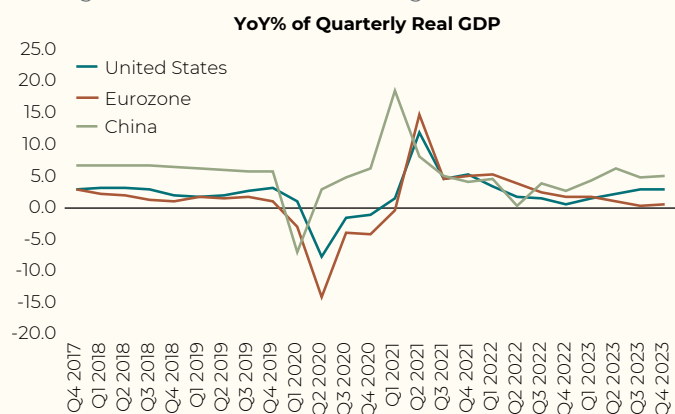
ECONOMIC UPDATE

The case for a soft landing in the US economy – a decline in inflation without serious economic damage – is building. Inflation is often a sign of an overheating economy and therefore, getting it under control means cooling down the economy. However, given the lags involved, central banks often overtighten, and cooling down often leads to a recession. Soft landings are rare, especially after big jumps in inflation. This time, however, it looks like the US Federal Reserve can achieve it. Given that the US is still the world's largest and most important economy, this matters for financial markets.

US real economic growth came in stronger than expected in the fourth quarter of last year and put full year 2023 growth at 3.1%. The widespread view that the US economy would experience a recession in 2023 was not just incorrect, it was significantly off the mark. This underscores the inherent challenges in economic forecasting and emphasises the caution investors should exercise in relying on such predictions.

With unemployment still below 4% and the continuous addition of large numbers of jobs to the US economy every month, household incomes are rising. And as inflation declines, the real purchasing power of these incomes rise. Consequently, consumer spending, which constitutes approximately 70% of US economic activity, is playing a pivotal role in driving the strong economic performance observed.

In contrast to the US, Eurozone growth was flat in the final quarter of 2023. While a technical recession was avoided, the European economy is clearly weak. Notably, Germany, its largest constituent, faced significant challenges due to its heavy dependence on manufacturing exports and the adverse impact of surging natural gas prices (which have now largely reversed). European households and firms also tend to have more floating-rate debt than their American counterparts, making them more vulnerable to higher interest rates.



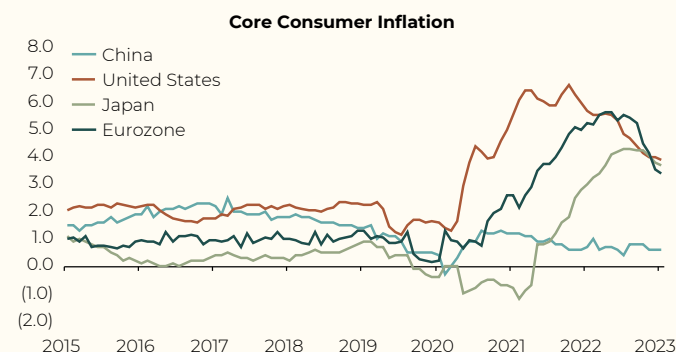
On the surface, Chinese real economic growth looks healthy, rising to 5.2% year-on-year in the fourth quarter. However, economy-wide inflation was negative, meaning that nominal growth was only around 4%. In fact, excluding 2020, it was the lowest nominal growth rate in the history of the data series, and behind that of the US and Europe, where inflation was higher. Nominal growth is important to company profits,

household incomes, and in particular, the ability to service debt (debt is always a nominal number). China's economy therefore remains fragile, and this is reflected in the ongoing declines in Chinese equity prices and bond yields.

The policy response from Beijing remains underwhelming given the nature of the challenge. During the month, the People's Bank of China (PBOC) cut the reserve requirement ratio for banks, potentially allowing for more lending to take place. But with depressed consumer and business confidence, it is not clear that much additional borrowing will take place.

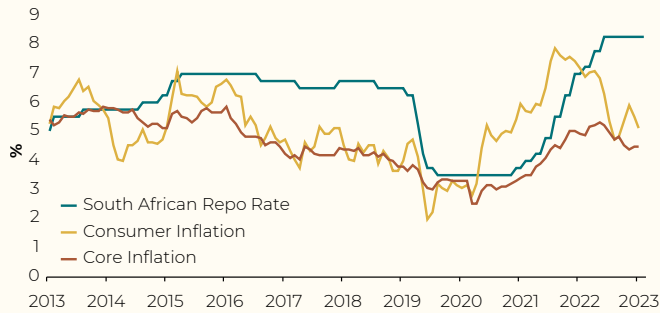
The PBOC's peers in Europe and the US kept policy unchanged during the month, as expected. The focus is rather on how soon and how far they will cut rates. In the case of the US Federal Reserve, there is no apparent rush. Inflation has declined meaningfully – and faster than expected – with the Fed's preferred inflation measure (core PCE) now running below 2% on a three and six-month annualised basis (though the 12-month rate of change is the more traditional metric, and that is still at 3%). However, this decline in inflation has not coincided with a material weakening in economic activity as noted above. The Fed will eventually start reducing rates, but the extent of cuts could be less than the market expects if growth holds up and the rare soft landing is successfully executed.

The European Central Bank, on the other hand, needs to more urgently think about cutting rates given the weakness in the European economy and the hard-ish landing underway. Historically, though, it has always been a conservative institution and unlike the Fed, its official mandate is only inflation – not both inflation and employment. Conflict in the Middle East, particularly the disruption of the Red Sea shipping channel, have been noted as potential sources of upward pressure on inflation, as is a tight labour market with low unemployment despite economic sluggishness. Nonetheless, inflation has declined rapidly. On a three and six-month annualised basis, core inflation is negative.



As was widely expected, the South African Reserve Bank's Monetary Policy Committee (MPC) left the repo rate unchanged at 8.25% in a unanimous decision. The MPC's tone is still on the hawkish side, however, noting that "serious upside risks to the inflation trajectory from global and domestic sources are evident".

However, the MPC is likely not too far away from cutting rates. Headline consumer inflation declined to 5.2% in December, while core inflation (excluding food and fuel prices) was 4.5%. The Reserve Bank expects inflation to average 5% this year and 4.6% next year. Despite its protestations to the contrary, this is sufficient progress on the inflation outlook to warrant lower rates. Once the Fed's cutting cycle is more clearly in view, the MPC should have the comfort to reduce the repo rate by around 100 basis points this year, and perhaps a bit more next year.



MARKET UPDATE

With concerns about China's slowing economy, geopolitical tensions in the Middle East, and instability in the Red Sea shipping route, global markets were volatile in January. The MSCI World Index was up 1.2% for the month, driven by solid gains in US indices while markets in the East struggled.

In the US, the Dow Jones (+1.2%), Nasdaq (+1.0%) and S&P 500 (1.6%) all ended the month higher. UK equities, on the other hand, recorded their worst month since October, with the FTSE-100 down 1.3% in January.

The liquidation of China Evergrande Group and the lack of stimulus from the government to boost the economy weighed on China's equity market. The Hang Seng ended the month 9.2% lower while the Shanghai Composite Index declined by 6.3%. The Nikkei had its best January performance since 1998, closing up 8.4% at 36,286 points.

On the local front, the JSE lagged major global markets, with the All Share Index falling 3.0% in January. Resources (-5.9%), financials (-2.9%) and industrials (-1.5%) all recorded losses. The rand was under continued pressure in January, and after touching 19.20/\$, recovered somewhat to close lower by 1.8%, ending at R18.67. Brent crude was up 6.1%, the platinum price was down 7.0%, and the gold price 1.1% lower (US\$2037,19/oz).

Will the SA Reserve Bank pull off a soft-landing? The reality is that high interest rates and inflation are probably not as big obstacles to economic growth as Eskom and Transnet. Moreover, market-based interest rates will remain high irrespective of what the Reserve Bank does, since they incorporate a large fiscal risk premium. While repo rate cuts later this year will give consumers some breathing room, the economy needs a meaningful improvement in its supply-side performance. As the MPC statement noted: "achieving a prudent public debt level, increasing the supply of energy, keeping administered price inflation low and real wage growth in line with productivity gains" are needed to improve domestic economic conditions.

GLOBAL EQUITIES



Nike

Nike reported a weak set of half year results on the back of double-digit growth in the previous year. Revenue increased 1% on a reported basis, though was down 1% in constant currency. Revenue from Nike Direct, which includes the group's digital sales and Nike-owned stores, was the key revenue driver, growing by 6% on a reported basis (+4% in constant currency). Digital revenue growth, a metric closely monitored given Nike's stated strategy of generating a larger proportion of sales through the channel, was up 4% during the period, which was lower than expectations and drove the overall revenue growth underperformance relative to consensus expectations. Geographically, North America and EMEA (Europe, the Middle East and Africa) reported revenue declines on a constant currency basis with the Greater China region reporting weaker-than-expected growth. Asia-Pacific and Latin America (APLA) was the only region to report revenue growth supported by South-east Asia, India, Korea and Mexico growing double-digits – a record quarter for the region. Overall, Nike's diluted earnings per share rose 21% to US\$1.03 as a result of a higher gross margin and lower group tax rate.

A key take-away from the result was management's plan to deliver cost savings of US\$2 billion over the next three years. These savings will be invested in innovation as the second half of the financial year marks the start of a multi-year product innovation cycle in which management plans to simplify the product portfolio and streamline business operations. Areas of potential saving include improving supply chain efficiencies, increasing automation and streamlining the organisational structure.



Givaudan

Global flavour and fragrance ingredient market leader, Givaudan reported a mixed 2023 full year performance, with Fragrance & Beauty sales growth compensating for the continued deceleration in the Taste & Wellbeing division. Reported sales for the group declined 2.8%, however, excluding foreign currency fluctuations, sales grew 4.1% to CHF6.9bn.

Sales in Latin America grew strongly (+15.1% in constant currency). This follows growth of 10.4% in 2022 and the region remains a key strategic growth area for the group. Europe, Africa and the Middle East (EAME) reported growth of 8.4%. While strong, this has slowed since the 11.9% reported in 2022. Growth across the Asia Pacific region was modest (+3.9%). North America continued to perform poorly, with sales down 6.8% following a 5.4% decline in 2022. Management is optimistic about the outlook as signs of a recovery emerged towards the end of 2023.

The group reported a significant recovery in gross margin (+240bps to 41.2%), allaying investor concerns regarding its ability to pass on price inflation. Earnings per share growth (+4.3%) was well ahead of consensus expectations, driving a positive market reaction. Free cash flow generation was healthy at CHF920 million supporting a 1.5% increase in the dividend to CHF68 per share. Management is confident in the group's ability to achieve its five-year strategy ending in 2025, with investors eagerly awaiting the group's new five-year strategy to 2030 expected to be announced later this year.



LVMH

Global luxury goods conglomerate, LVMH reported a decent full year 2023 performance, with sales growing 13% (in constant currency) and 9% on a reported basis to EUR86.1bn. This result was achieved within a challenging environment characterised by destocking in the US and the cancellation of key industry events due to the conflict in the Middle East.

Regionally, LVMH's largest market, Asia (31% of sales) reported sales growth of 18%. This was supported by a recovery in mainland China, where travel retail remains below 2019 levels. The US and Europe, contributing 50% to sales cumulatively, reported growth of 4% and 13%, respectively, with the US recovering during the second half of the year. Despite slowing in the fourth quarter, Japan reported the highest performance in the group, with sales growth of 28%.

While management remain concerned about the ongoing conflict in the Middle East and the impact on consumer sentiment, the group expects interest rate cuts and the upcoming US election to support macro-economic growth and luxury demand. In line with growth in earnings, management has proposed a dividend of EUR13 (+8.3%) per share.



Atlas Copco

Global industrial manufacturer, Atlas Copco reported a strong full year 2023 result with profit up 19% to SEK28bn. The strong performance was driven by increased demand for the group's industrial compressors, rental equipment and solutions applied to the production of solar panels, batteries, automotive vehicles and aircraft.

Despite the strong performance, orders, an indication of future revenue growth, decelerated throughout the course of 2023 as industrial customers became increasingly concerned about the macro-economic outlook. Orders for the year grew by 8%, driven by acquisitions, with minimal organic growth. Looking ahead, management indicated that customer activity is expected to remain at current levels. This guidance underperformed consensus expectations, which forecast the group's Vacuum Technique to have benefitted from a recovery in semiconductor activity along with sustained growth momentum in commercial industrial activity.

Atlas Copco has a strong balance sheet with minimal net debt, placing the group in a good position to navigate a potential market downturn. Supported by healthy cash generation, the Board proposed an ordinary dividend of SEK2.80 (+21.7%), to be paid in two equal instalments in April and October 2024.

LOCAL EQUITIES



Prosus delivered interim 2024 results that showed continued progress on their drive towards trading profitability through a combination of healthy core revenue growth, improving Tencent results, and greater management and operational oversight of controlled and associate businesses. Revenue growth at an overall portfolio level was flat but still an improvement over the 6% decline recorded at financial year-end six months ago. Excluding Tencent however, core portfolio revenue grew 16% driven by strong growth across all segments, with the exception of EdTech.

Profitability (or reduced losses) was the highlight, with the core portfolio minimising its negative trading profit margin from (-19%) to (-5%). Classifieds and Etail were the two segments behind this result. Looking ahead, management have brought forward their expectations for trading profitability to the second half of 2024 (originally guided for the first half of 2025), emphasising that they have made good progress but will now turn their attention to Edtech, Food Delivery and growing value in Payments and Fintech. Prosus remained in a healthy financial position, with US\$15.1bn in cash against US\$15.1bn in interest-bearing debt.

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