Prosperity

October 2023

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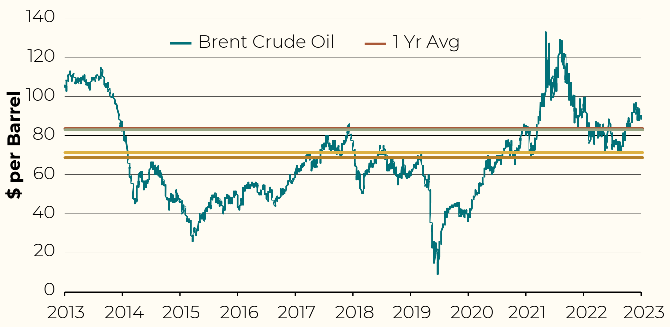
Private Clients
by Old Mutual Wealth

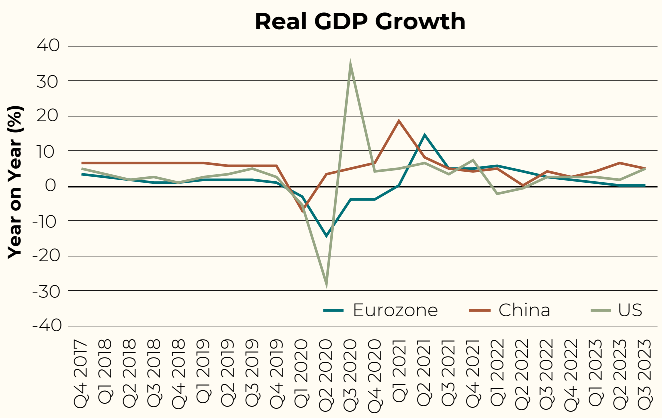
ECONOMIC UPDATE

News headlines in October were dominated by horrific scenes from the Middle East, where several thousand lives have tragically been lost. This is a conflict with deep and complex roots, with the ramifications extending beyond the region to the wider global economy – most notably to energy markets.



Fifty years ago, Arab oil exporters instituted an oil embargo against Western nations sympathetic to Israel in the wake of the Yom Kippur war. A repeat would be damaging to the world economy, but so far, there is no sign of this happening. Much has changed in the past five decades in terms of the politics of the region (most Middle Eastern states now recognise Israel), the structure of the global oil industry (the US is now the largest producer), and the nature of oil demand (global economic activity is much less energy intensive). The Brent oil price ended the month at US$90 per barrel, below where it started.

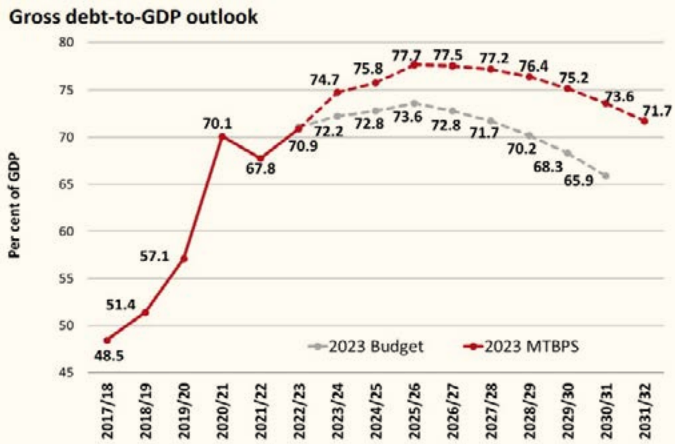
For financial markets, the much bigger story is the ongoing strength of the US economy, which posted a blockbuster 4.9% quarterly growth rate in the third quarter (2.9% year-on-year). This growth was boosted by strong consumer spending, which in turn was supported by solid gains in employment and wages. However, given that spending has grown faster than incomes, consumers appear to be tapping into their savings. As such, the good times are not likely to last, and the rate of growth should slow heading into next year.



In the meantime, the stronger US growth numbers have placed upward pressure on market-based interest rates such as bond yields and mortgage rates. This should contribute to slower growth next year. The Federal Reserve is unlikely to raise its policy rate much further, if at all, since these higher market-based rates should do the job. For instance, the average mortgage rate is approaching 8%, an unaffordable rate for many would-be home buyers. It helps that US inflation continues to decline, though there are enough signs of stickiness for the Fed to remain cautious and not pivot to rate cuts any time soon.

US growth is also notably faster than in the Eurozone, where third quarter GDP growth was negative. The more recent October flash S&P Global Purchasing Managers' Indices also illustrate this divergence. The Composite (manufacturing and services) Index was in positive territory for the US at 51 points, but deeply negative for the Eurozone at 46.5. With Eurozone inflation also falling more than expected in October, the European Central Bank's hiking cycle is most likely over. It left rates unchanged at its October meeting, following 10 consecutive increases.

China's economic slide appears to be bottoming. Real GDP grew a bit more than expected in the third quarter (4.9% year-on-year), with consumer spending and manufacturing picking up pace. However, the drag from property continues. Despite several policy initiatives to support the sector, real estate is likely to be a source of weakness for a long time as a poor demographic outlook, high levels of developer indebtedness and a loss of confidence in the asset class remain headwinds.



Locally, the euphoria of the Springbok World Cup victory was tempered by a tough-love Medium-Term Budget Policy Statement (MTBPS). As expected, the MTBPS showed wider deficits than projected in February due to the R56.8bn tax revenue shortfall. The 2023/24 budget deficit is now projected at 4.9% of GDP instead of 4%. This means that debt-to-GDP will peak later and at a higher level. SA's debt-to-GDP ratio is not high by global standards, but has increased rapidly in recent years, and since government borrowing costs are high, this is not a sustainable situation.

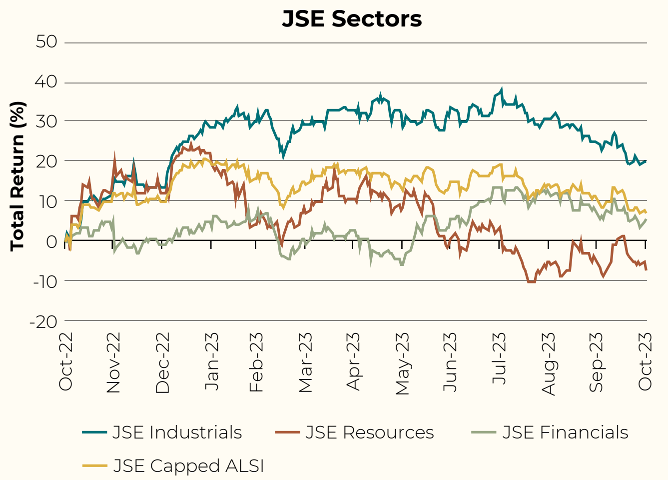
Major policy announcements are made in the February Budget, not the MTBPS. And with an election next year, these announcements may come later. However, the finance minister has promised a comprehensive spending review, with R85 billion in spending cuts pencilled in over the medium term.

The one positive from the MTBPS is that government remains committed to getting its finances in order, despite the looming election. Typically, governments in many other economies try to "juice" the economy and engage in populist giveaways ahead of elections. There is little sign of this in SA. The MTBPS also maintains a strong emphasis on raising economic growth levels. This is ultimately the only thing that will make the fiscal numbers work out in the long term.

MARKET UPDATE

October marked the third consecutive month that the US market posted losses, largely driven by persistently high global interest rates, subdued earnings forecasts and the Middle East conflict. The Nasdaq fell 2.8%, the S&P 500 declined by 1.4%, and the Dow Jones was 1.4% lower. In the UK, while inflation remained unchanged at 6.7% year-on-year, the FTSE-100 slid 3.8% in October.

Ongoing uncertainty around China's economic recovery weighed on its equity markets, and for the third consecutive month, foreigners were net sellers of Chinese equities. During October, the Hang Seng lost 3.9%, and the Shanghai Composite Index (-2.9%) and the Nikkei (-3.1%) also recorded losses.



In SA, the All Share Index was down 3.8% in October. All sectors declined in line with global markets, with Resources (-4.3%), Industrials (-4.7%) and Financials (-3.1%) ending the month lower. The rand strengthened by 1.5% against the US dollar, ending at R18.64. Brent crude was down 8.3%, while iron ore (+0.5%) and platinum prices (+3.2%) rose. On 27 October, the gold price rose above the US$2 000 level, eventually ending the month 7.3% higher at US$1 983/oz.

GLOBAL EQUITIES

Visa

Leading global payments technology company, Visa reported strong 2023 full year results as the group continues to experience a healthy recovery across key geographies despite macroeconomic concerns. Payment volumes over the year increased by 9%, which was similar to the growth the company reported at its interim results six months ago. Cross-border volumes (+20%), which drive the higher-margin international transaction revenues, stood out once again. This trend of faster-growing international transactions highlights how Visa continues to benefit from increased travel post the COVID-19 pandemic. Over the course of the year, rebounding Asian travel was the primary driver of international transaction volumes, as Asian economies reopened their borders later than other countries. Excluding Visa's European operations (which have been affected by the exclusion of its Russian operations), cross-border volumes rose 25% year-on-year.

Group revenue for the year was up 11% to US$32.7bn. Revenue growth was driven by higher payment volumes, cross-border volumes and processed transactions. Excluding currency movements, revenues rose at a faster pace – up 13% over the year. Net income for the period was US$17.3bn or US$8.28 per share, an increase of 15% and 18%, respectively. Growth in earnings was largely in line with our expectations as we expected Visa to grow at almost 20% for the year on the back of increased international travel. During the final quarter of the financial year, the group repurchased US$4.1bn worth of shares at an average price of US$241 per share. Visa has repurchased US$12.4bn worth of shares over the last year, which equates to over 2.5% of its current market capitalisation.

Alphabet

Alphabet reported solid third quarter results showing good year-on-year revenue growth from Google Advertising (+9.5%) and continued growth in Google Cloud (+22.5%). Operating income was up (+24.6%), with good margin expansion across Google Services (Advertising, hardware, Play store, subscriptions) and Google Cloud. Total revenue grew by 11%, with both Search (+11%) and YouTube (+12.5%) returning to double-digit growth. Taken together with a lower loss on equity instruments and lower tax rate, earnings per share grew 46.2% to US$1.55.

The market, however, was unimpressed with the results, subsequently trading the share down almost 12% post release. This was largely due to slowing Cloud revenue growth and a decline in Cloud margins, when measured on a quarter-on-quarter basis. Given that Cloud is the fastest growing segment since launch, the market was understandably concerned about its future growth trajectory.

As long-term shareholders, three points are worth keeping in mind. Firstly, Alphabet's share price was up 7.7% compared to the S&P500's -2.1% over the month prior to the results; and secondly, the first and third quarters are typically the weakest in Alphabet's financial year. Lastly and perhaps most importantly, direct comparisons between Google Cloud Platform (GCP) and Microsoft's Azure are unfair owing to each service maintaining different growth drivers. Simplistically, growth in Microsoft's suite of software contributes to growth in Azure while growth in Google Search does not directly contribute to GCP growth. It has also become clearer that Microsoft had a substantial head-start in generative AI relative to peers. This is not in terms of the underlying technology but rather a commercialisation strategy. The typically conservative Google maintains troves of data and had been involved in AI since the mid-2000's, however, the group is still in the experimental phase of integrating generative AI into Search, also termed the Search Generative Experience (SGE). While Alphabet's generative AI ambitions still require much investment over the short term, once deemed fit for mass adoption, SGE and generative AI integration across Google's massive advertising properties holds the promise of more efficient and effective marketing, which will drive both growth in users and advertisers, and ultimately profitability.

LOCAL EQUITIES

Bytes Group

Bytes Technology Group, one of the UK's leading software businesses, reported another strong set of results for the 2024 interim financial period. The group continued to benefit from the UK corporate and public sectors' long-term investment in IT services. Gross invoiced income (a metric that best reflects sales growth in the business) rose 37.6% to £1.1bn, exceeding £1bn in the first half of a financial year for the first time. Growth was reported across all of the group's business areas; namely software, hardware and services. Across client type, corporates – which make up the bulk of gross profit (67%) – increased by 25.7%. The lower margin public sector reported a 44.4% increase in gross invoiced income following new large public sector Microsoft contracts. Overall, earnings per share rose 17% to 10.6 pence, which was less than the increase in gross invoiced income as the larger public sector contracts were at lower margins than the rest of the group's contracts.

During the period, Bytes won a five-year £860m contract to accelerate the adoption of Microsoft cloud services for the UK's National Health Services (NHS). This was Microsoft's largest ever government contract win in the UK. For the period under review, the contract added over £140m to Bytes' revenue. While the contract is sizeable, it weighed on the group's margins, with management expecting services in subsequent years arising from the project to be at more favourable margins. This is consistent with previous large multi-year public sector projects Bytes has been involved in. The group remains highly cash generative with no debt on its balance sheet, which we believe will continue to stand them in good stead in the current environment. We retain our positive view on Bytes, with the current share price trading below our estimate of fair value.

Clicks

Clicks reported strong full year results that were largely in line with expectations and were characterised by a stronger performance in the second half of the year. Excluding vaccinations, group turnover was up 8.2%, with the group recording market share gains across all product lines and segments. Growth of 12.2% in the retail segment drove turnover growth over the period. Performance of UPD, the distribution business, was more muted (+1.5%) due to a lower-than-expected increase in the regulated single exit price (SEP) of medicines granted by the Department of Health (DoH). Retail sales growth was driven by strong performance in the beauty and personal care segment (+18.3%). Margins were higher in the retail segment as a result of increased private label contribution and a shift away from lower margin vaccination sales. Adjusted diluted headline earnings per share rose 11.5% and operating margins increased 30bps to 8.7%.

In the first half of the year, the Constitutional Court found that Clicks had contravened regulations of the Pharmacy Act and ruled in favour of the Independent Community Pharmacy Association (ICPA) after a seven-year long battle against the group's ownership of both dispensing and manufacturing pharmacies. This ruling meant that the DoH has the power to revoke Clicks' pharmacy licence. However, the court suggested that Clicks be given the opportunity to divest itself of Unicorn Pharmaceutical – Clicks' manufacturing subsidiary. Although Unicorn Pharmaceutical is fully owned by New Clicks and not Clicks, it is a 100% subsidiary of the JSE-listed entity Clicks Holdings. Unicorn-manufactured drugs contributed 10.2% of Pharmacy revenues and 2% of Retail turnover, according to Clicks, making up about 215 generics. Management stated that they are engaging with the Department of Health (DoH) to come to a resolution but in the time being no restrictions were placed on the sale of private label products through their dispensaries. Since the announcement, there have been ongoing discussions with management. The DoH and Clicks management stated that the resolution of the matter needs to be expedited.

Looking ahead, the outlook remains challenging due to loadshedding and a constrained consumer. Management are confident in their defensive business model that still provides numerous opportunities for organic growth.

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