

Prosperity

May 2023

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Private Clients
by  Old Mutual Wealth

ECONOMIC UPDATE



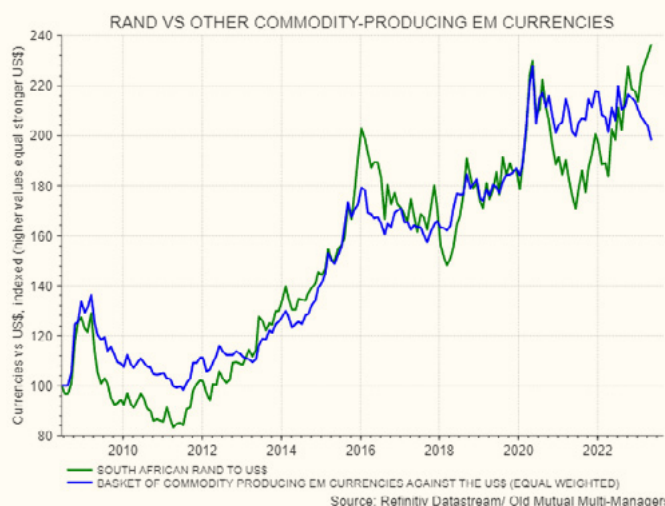
South Africa is now in the grip of an interest rate squeeze, with rates having risen sharply since the start of the year in absolute terms and relative to what was expected. Despite a bigger-than-expected decline in the April inflation rate to 6.8% year-on-year from 7.1%, the SA Reserve Bank’s Monetary Policy Committee (MPC) raised the repo rate by 50 basis points to 8.25% in a unanimous decision. It was 7% at the start of the year and 3.5% at the bottom of the cycle. It is also now above the average for the past decade of 5.7%.

For the first time, the MPC statement acknowledges that policy is now in “restrictive” territory. In other words, the MPC hiked while agreeing that rates are hurting the economy.

Unlike the rest of the world, or at least the developed countries, South Africa does not have a demand-led inflation problem. The economy is simply too weak for that. Most of the inflation shock has come from supply side pressures, namely food and fuel prices, and to the extent that firms pass on the cost of loadshedding. Higher interest rates cannot address supply constraints. All it can do is prevent firms from passing on higher input costs by weakening what little demand remains left. This so-called second round impact of higher input costs is what the Reserve Bank is particularly concerned about. The same goes for a weaker currency, which has emerged in the past few weeks as a major risk factor. The Reserve Bank can ignore a weaker currency if it thinks the effects will be temporary, but when there are concerns that businesses will push up prices because of the weaker rand, it acts. And when the currency itself is at risk of completely falling out of bed and destabilising the financial system, the Bank also steps in.

The rand lost almost 8% against the dollar in the month of May, on the way to a record low close of R19.82 per dollar. Perhaps surprisingly, this does not make it into the top 10 worst months of the past 30 years, but it is still clearly a sharp move. Even the MPC’s rate hike did not stem the tide. It was only when the US Congress raised the debt ceiling for two years – removing a serious tail risk to the global financial system – that the rand stabilised somewhat. This is a reminder that, as much as the current rand weakness is mostly about loadshedding, the global backdrop always matters. When foreign investors feel risk averse, the South African rand is often the first thing they

sell. Conversely, while the electricity situation (and in particular, how we get through the cold winter months when demand spikes) will clearly be key for the rand’s immediate fortunes, the global backdrop will also matter.



It is not just the policy short-term interest rate that rose in May. South African government bonds also came under severe pressure. As bonds sold off, yields jumped to levels approaching those of the global COVID-19 panic of early 2020, reflecting the fear of a similar shutdown of the economy. A sustained increase in the government’s borrowing costs can increase interest payments, leaving less money for other important areas.



The real predicament is that the more the market worries about the sustainability of state finances, the bigger the risk premium built into government bond yields. This can create a negative spiral. The more the yields rise, the more the government must compensate by cutting spending, not only to make the numbers add up, but also to convince the market that the numbers will add up. However, with an election looming next year, the market is worried about spending discipline.

It would be a different story if the economy was growing strongly, and tax revenues exceeded expectations. This is what happened during the short-lived 2021 and 2022 commodity price boom. But since the electricity supply outlook has deteriorated in recent months and economic growth forecasts have been cut, tax revenues are likely to fall short of the Budget projections.

Nonetheless, the bond yields already discount a lot of bad news. As long as the Reserve Bank remains focused on fighting inflation – which its latest actions suggest is the case – double-digit bond yields offer attractive value for patient investors.

MARKET UPDATE

Global equity markets had quite a bit of news to digest in May. Several factors added to volatile market movements, including economic data, geopolitical developments, and shifting central bank policies.

In the US, equity markets were resilient despite ongoing concerns about rising interest rates and inflation. The S&P 500 managed to end the month marginally higher (+0.3%), while the NASDAQ Composite (+5.9%) closed at its highest level since August 2022. Technology stocks continued to lead the gains, benefiting from increased digitalisation trends and mentions of "AI" in most earnings calls.

In Europe, equity markets faced some headwinds as economic growth moderated. The major indices (such as the FTSE 100 in the UK, the DAX in Germany, and the CAC 40 in France) experienced some volatility throughout the month, with all the European indices closing 3% - 5% lower. Asian markets had a mixed performance in May. China's equity markets faced downward pressure due to concerns about regulatory crackdowns on technology companies, with the Shanghai 300 closing 5.7% lower. On the other hand, Japan's Nikkei 225 had its best month in two-and-a-half years, ending May 7% higher.

On the local front, the All Share Index lost 4% as SA equities felt the brunt of a sliding currency. All sectors ended the month in negative territory, with Financials (-8.1%) recording the steepest decline, followed by Industrials (-3.1%) and Resources (-2.1%).

In the currency markets, the US dollar remained relatively stable against major currencies in May. The Federal Reserve's commitment to maintaining accommodative monetary policies, combined with positive economic indicators, provided support for the dollar. However, other factors such as geopolitical tensions and central bank actions in other countries influenced currency movements. The euro faced some pressure due to concerns over the economic recovery in the Eurozone and uncertainty surrounding the European Central Bank's monetary policy decisions and lost 3% to the US dollar to close at 1.069. It felt like a one-way move for the rand, and in one of its worst months in recent history, traded at new lows to the dollar, ending the month 7.9% weaker at R19.72.

Brent Crude Oil traded 8.5% lower to close May at US\$72.70/barrel while precious metal prices also pulled back. Gold was 1.3% lower at US\$1 962 and platinum fell 7.3% to US\$995.

GLOBAL EQUITIES



Visa

Visa, the world's largest payments technology company, reported strong second-quarter 2023 results that showed that despite well-documented macro concerns, the business continues to enjoy a strong recovery across key geographies. Payment volumes for the second quarter rose 10% year-on-year, ahead of the 7% increase in the first quarter. Cross-border volumes, which drive the higher-margin international transaction revenues, increased 24% year-on-year. While this was slower than the 38% increase reported for full year 2022, cross-border volumes are still growing at an impressive rate. The trend of faster-growing international transactions highlights how Visa continues to benefit from increased travel post the pandemic. During the second quarter, rebounding Asian travel was the primary driver of international transaction volumes. Excluding the group's European operations, which have been affected by the exclusion of its Russian operations, cross-border volumes rose 32% year-on-year.

Group revenue for the quarter was up 11% to US\$8bn, driven by the growth in payment volumes, cross-border volumes and processed transactions. Excluding currency movements, revenues rose at a faster pace, up 13% over the quarter. Net income for the quarter was US\$4.3bn or US\$2.03 per share, an increase of 17% and 20% respectively. Growth in earnings was in line with management's previous guidance of approximately 20% over the quarter. The group's expenses were well managed, which resulted in higher margins. During the quarter, the group repurchased US\$2.2bn worth of shares at an average price of US\$222 per share.



Apple

Given Apple's status as a bellwether for the state of consumers, the group's latest quarterly earnings update was among the most highly anticipated of the last few weeks. Despite investor concerns leading up to the results, the company managed to beat revenue and earnings expectations for the second quarter, which saw the share price rise in reaction to the results. However, in absolute terms, revenue for the period was 3% lower at US\$94.8bn, while earnings per share remained unchanged at US\$1.52. Average analyst expectations were for revenue and earnings of US\$93.1bn and US\$1.44, respectively.

Apple's active installed base (i.e. the total number of devices it has in the market) exceeded two billion, reaching all-time highs. Management has increasingly prioritised this metric as the group has shifted focus to its services business, which grew revenue 5% during the quarter. While service growth was impacted by a slowdown in

digital advertising and mobile gaming, it still represented a record quarter for the group. Related to the group's service growth was the disclosure of over 975 million current paid subscribers across Apple's various services. This was an increase of 150 million from a year ago and nearly double the paid subscriptions from three years back. Apple ended the quarter with a net cash position of US\$57bn, paid dividends of US\$3.7bn, and carried out US\$23bn of share repurchases. This continues a trend of utilising excess cash on its balance sheet to reduce share count, which has been supportive of earnings growth.



Walt Disney

Media and entertainment giant, Walt Disney, reported mixed second quarter performance as higher revenue and operating income from its Parks and direct-to-consumer (DTC) businesses were offset by a weaker performance from traditional linear (cable & broadcasting) networks. Group revenue increased 13% over the quarter, driven by increased average revenue per subscriber as well as higher park attendance, increased guest spending and increased average park and hotel prices. Operating income, however, declined 11% due to higher production and sports-programming costs.

Management reiterated their commitment to improving the profitability of the DTC platforms and are prioritising the pricing strategy, integration of advertising, and rationalising the volume of general entertainment content. The group continued to invest in its world-renowned parks, adding new Frozen and Zootopia experiences. Looking ahead, management continues to expect high single-digit revenue and earnings growth for 2023.

LOCAL EQUITIES



Richemont

Following robust demand for its flagship brands, Richemont, the world's second largest luxury goods group, reported a record performance for full year 2023. Revenue was further supported by modest price increases while operating income benefitted from increased manufacturing capacity utilisation and continued operational cost containment. Overall, revenue and operating income rose 14% and 34%, respectively.

The sale of luxury e-commerce platform, YNAP, to FARFETCH, is in progress and management expect the transaction to be completed by the end of 2023. In the short term, management are cautiously

optimistic about the outlook for the year, expecting a harder landing in the US than market participants are suggesting. Over the longer term, in response to strong demand, where waiting lists have been capped at two years, the group is investing in additional manufacturing capacity. Despite continued investment in the group's capacity and brand desirability, the group's net cash position has strengthened to €6.5bn, prompting the executive team to propose an 11% increase in the group's ordinary dividend to CHF2.50 per share as well as a special dividend of CHF1.00 per share.



Vodacom

Despite record loadshedding, higher costs of living, sharp interest rate hikes and foreign exchange rate volatility across operating regions, Vodacom reported strong full year 2023 results supported by the acquisition of Vodafone Egypt. Group revenue was up 4.9% in constant currency, with group service revenue up 7.2% excluding Vodacom Egypt, which was consolidated on 8 December 2022. Financial service revenue growth (+14.3%) was particularly strong, contributing 10% of group service revenue. Since 2020, Vodacom has spent over R4bn on back-up power solutions to keep network availability above 94%. This contributed to accelerated demand for data – up 45.4% in the fourth quarter. Growth in international operations was underpinned by a 31.1% increase in M-Pesa revenue.

Group earnings before interest, tax, depreciation and amortisation increased 13.2% (3.6% in constant currency), reflecting improvements in profitability, notably in the second half of the year. However, despite this, net profit over the year was up by only 2.1% due to loadshedding in SA, higher interest charges, start-up losses in Ethiopia and higher inflation across markets. The board declared a dividend of R3.30 per share, bringing the total dividend for the year to R6.70.



Ninety-One

Global asset manager, Ninety-One reported full year results reflective of the challenging investment and operating environment. Over the period, the asset manager saw net outflows of £10.6bn, as clients – impacted by rising inflation and interest rates – exited investment markets in search of liquidity. Because of the tough market, the group reported a 10% decrease in assets under management (AUM) and portfolio growth through market moves in the second half of the year were offset by outflows from a few large institutional clients.

Adjusted operating revenue for the period declined 5%. Cost controls through the second half of the year resulted in operating expenses declining 2%. Subsequently, operating profit fell 10% to £206.9m. The adjusted operating profit margin fell from 34.7% to 32.7%, in line with earnings per share declining from 19.2p to 17.3p. The board declared a final dividend of 6.7p, bringing the full year dividend to 13.2p (-10%).



Bytes Group

Bytes Technology Group, one of the UK's leading software businesses, reported strong results for the 2023 financial year. The performance was consistent with what we have come to expect from the group over the years, which is illustrative of continued investment in IT services from corporates and the public sector across the UK. Gross invoiced income (a metric that best reflects sales growth in the business) rose 19.1% to £1.4bn. Over the last decade, gross invoiced income has grown by a compound annual growth rate of 25.7%, which is reflective of the structural growth that exists in Bytes' key markets. Growth in the current period was across all of the group's business areas – software, hardware and services. Across client type, corporates – which make up the bulk of gross profit (65%) – increased by 21%. This is a continuation of the strong demand we have seen since 2020. The lower margin public sector reported an 18% increase in gross invoiced income, coupled with an increase in margin. Overall, operating profit for the year was up 20.6% to £50.9m, which was largely in line with our expectations.

During the period, management increased headcount by 20% to 930. This was a slight acceleration from the mid-teen growth in prior years and is reflective of the opportunities that management are seeing in the market. In terms of capital allocation, the board proposed a final dividend of 5.1p, an increase of 21.4% over the prior year as well as a special dividend of 7.5p. 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 constructive view on Bytes, with the current share price trading below our estimate of fair value.

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