INTEGRAL Asset Management

The Outlook

July 2024

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Politics continues to dominate economics.

In recent years we have highlighted the rising geopolitical and intra-country tensions and lamented that politics continues to dominate economics. And now by their actions, politicians face Ray Dalio's five big forces that continue to shape the global economic cycle. These forces are:

- ✓ Economy and high levels of debt,
- ✓ Internal peace or conflict,
- ✓ External issues between countries,
- ✓ Epidemics and climate change, and
- ✓ Technology and Artificial Intelligence (AI).

Polarization is increasingly evident across the globe, affecting societies in both established and younger democracies such as our own. Growing disparities in wealth and income are exacerbating social and political divisions. And politicians have become increasingly divisive and gridlock is the order of the day. The announcement of snap elections in the UK and France is evidence of this.

Adding to the turmoil, the cycle of higher global interest rates is impacting disposable income in most countries, and the consensus of the impact within and between countries is widening.

During the Biden-Trump debate on Thursday, the key higher-level issues were China, funding NATO, and the economy. As we head toward the US elections in November, we expect markets - bonds, stocks, and currencies - to be volatile, with the market constantly second-guessing a Biden or Trump victory and a Fed rate cut.

Around the world polarization is being fuelled by the tension between the US and China, the G7 and BRICS+, and the two major wars. Uncontrolled immigration out of Africa and South America is also a divisive factor. The many polarization issues together with concerns about the upcoming elections in the UK, France, and the US, the two wars, are having an inevitable knock-on effect on economies and global trade.

At the same time, corporates have had to deal with ESG matters and the carbon reduction demands associated with the Green Energy Transition. The notion of doing away with fossil fuels is a monumental undertaking with far-reaching economic implications. Just the thought of replacing vehicle, marine, and airline fuels is mind-boggling and has potential extreme knock-on effects on the global economy.

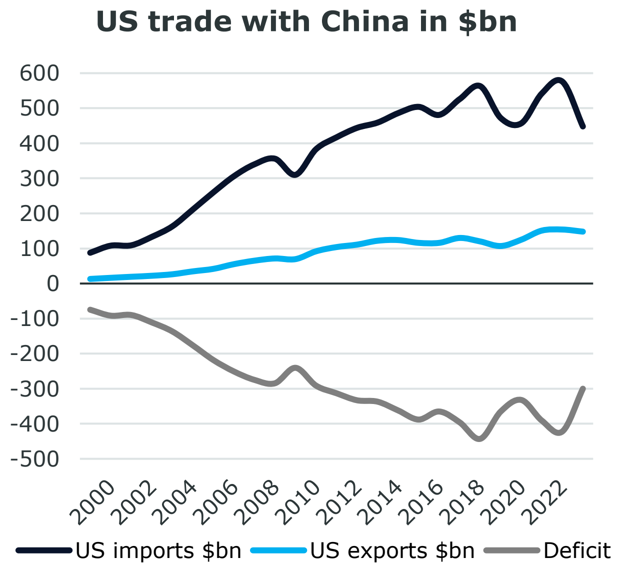
Despite the challenges, listed companies keep forging ahead, ever-increasing – AI is the next revolution - and productive.

US-China relations – when elephants fight.

The tense US-China relationship started during Obama's term and under Trump gave way to an all-out trade war – "*make America great again*" (MAGA). Subsequently, Biden has kept up the pressure. Since the US and China account for around 40% of global GDP and close to 25% of global trade, the sanctions and trade tariffs being imposed will impact global businesses and consumers in a myriad of ways.

Over the past year, the Chinese economy has suffered under the housing crisis, mounting debt, worsening geopolitics, and trade tariffs. The chart below depicts US trade with China and shows that the deficit peaked in 2023 at $422bn with exports at $154bn and imports at $576bn. In 2023 China accounted for about 15% of US imports and 5% of exports. Since the Great Financial Crisis, the cumulative US trade deficit with China is $5tr.

Biden and Trump label China's excess and superior manufacturing base as unfair and want to impose more tariffs on Chinese goods. Who will get hurt whilst the elephants fight?



Meanwhile, the South China Morning Post reports that "*Globalization isn't going away. It's getting a multipolar makeover. From service export growth to green energy transitions, economies can still prosper from trade amid changes in the global economy*".

The good news is that the resilience and enterprise of the Chinese are being channeled via its *One Belt, One Road* projects. This is opening new marine logistics, tourism, and maritime businesses, driven by green, circular advances and AI.

Similarly, sanctions and tariffs on Russian oil, gas, and commodities are forcing countries to re-evaluate their trading partners based on economic and national security concerns. The IMF says that "*Global economic ties are changing in ways we have not seen since the end of the Cold War and that foreign direct investment flows are also being re-directed along geopolitical lines*. *All of this is not necessarily bad, but if the trend continues, we could see a broad retreat from global rules of engagement and, with it, a significant reversal of the gains from economic integration* ".

US economy and equities.

Last Thursday, the Biden-Trump debate consensus was that Biden lost to Trump. Suffice it to say that Biden dithered but brushed aside mounting calls from prominent Democrats to step aside following his disastrous debate against Trump. We will live with this US election uncertainty until 5 November.

On Friday, the Fed's favoured inflation gauge came out at 2.6% y/y with the market now factoring in a 65% probability of a 25-50bps cut in rates this year. Attention will likely shift to employment data, growth, and the November elections.

Although pressure on household income is rising a surge in expenditure on the back of the Science and Chips and Inflation Reduction Acts has added about $800bn - above the trend average - to Private Fixed Investment. The extra jobs created are being filled by persistent immigration.

Back to Dalio's "forces", the driving force in the US is generative AI. What is happening is akin to a Fifth Economic Revolution. This is real, transformative, and is adding to productivity and growth. The major beneficiaries are the developers - the "Magnificent 7" who deploy their goods and services to billions of global corporates/customers. Is this too much of a good thing? No, in many respects it is only the beginning, with the speed of implementation, Nvidia for example, caught many by surprise and chased up stock market valuations.

But there is no free lunch according to Victor Davis

Hansen – The Logic in All the Madness (Hoover Institution):

- ✓ *A non-existent border that has leaked 10m illegal aliens in recent years,*
- ✓ *An economy shackled by counter-productive green mandates,*
- ✓ *Oil and gas production curbed and the strategic petroleum reserve drained,*
- ✓ *Attempts by the opposition party to remove political opponents from the ballot,*
- ✓ *Emboldening Iran's Axis of Resistance against Israel, and*
- ✓ *Borrowing $1tr every 90 days at around 5% on the near $36tr of ballooning national debt,*

Year-to-date (YTD), the Nasdaq and the S&P 500 are, respectively, up 17.1% and 14.6%, whereas gold is up 12.5%, and the JSE ALSI is up 3.9% in dollars and 3.6% in rands. Information Technology (+28.3%), Communication Services (+24.5%), and Insurance (+14.7%) lead the major sub-indices YTD ranking.

Outside of the Magnificent 7, YTD the Russell 2000 is up a meagre 0.2%, while Real Estate is down 4.8%. With such massive exposure to interest rates, property is a red flag. The gold price, although it generates no yield, has played the defensive role that we expected.

US major equity indices (ranked by 2024 YTD performance)

US Equity Indices	Latest	2024 YTD
Information technology	4,360	28.3%
Communication Services	306	24.5%
Nasdaq	19,700	17.1%
Insurance	733	14.7%
S&P 500	5,465	14.6%
Banks	394	12.2%
Financials	686	9.5%
Utilities	350	8.7%
Consumer Staples	825	8.3%
Industrials	1,038	7.6%
Healthcare	1,706	7.3%
Energy	680	6.2%
JSE ALSI	4,441	5.6%
Consumer Discretionary	1,485	4.7%
Materials	563	4.3%
DJI	39,150	3.9%
Russell 2000	2,986	0.2%
Real Estate	240	-4.8%

Source: Refinitiv - excludes dividends

The S&P 500's top 7 stocks now account for over 30% of the index and 64% of the Nasdaq, with Nvidia leading the way up 149% YTD, followed by Meta (+42%), Alphabet (+30%), Amazon (+27%), Microsoft (+19%), and Apple (+9%). These are all highly rated (+PE 30x) stocks where the market sees endless growth in earnings ahead. Eric Peters of River One AM explains, "*In the US there are two types of investors, those who own Nvidia and those who don't*", adding that "*no one who's long is selling now, not unless there's a proper recession, the EU is low in investor's minds (French elections), and China is un-investable". Peters adds some caution, "Whilst all roads lead to Nvidia*, if *softer inflation leads people to worry about slowing growth as opposed to being a catalyst for lower rates, then that's something new."*

South Africa, the GNU outcome is the best that the market could have hoped for.

Soon after failing to secure a majority vote in the 29 May elections, the ANC (40.2%) announced the establishment of a GNU. Including the DA, eleven parties signed the SOI to join the ANC-led formation. Vowing not to work with the DA, ANC splinter groups, the MK, and the EFF (combined 24.5%), chose to remain in the opposition ranks. From a market perspective, this is a bullet dodged for now.

Although the ANC was vulnerable, it was streetwise in getting the DA to agree to re-elect Ramaphosa as president without agreed cabinet positions.

GNU	No.	Parties	Compensatory seats		Regional seats		Combined seats	
1	1	ANC	73	36.5%	86	43.0%	159	39.8%
2	2	DA	42	21.0%	45	22.5%	87	21.8%
	3	MK	31	15.5%	27	13.5%	58	14.5%
	4	EFF	17	8.5%	22	11.0%	39	9.8%
3	5	IFP	8	4.0%	9	4.5%	17	4.3%
4	6	PA	5	2.5%	4	2.0%	9	2.3%
5	7	VF Plus	4	2.0%	2	1.0%	6	1.5%
	8	ActionSA	4	2.0%	2	1.0%	6	1.5%
	9	ACDP	3	1.5%		0.0%	3	0.8%
6	10	UDM	2	1.0%	1	0.5%	3	0.8%
	11	ATM	2	1.0%		0.0%	2	0.5%
7	12	Al Jama	2	1.0%		0.0%	2	0.5%
	13	BOSA	2	1.0%		0.0%	2	0.5%
	14	NCC	1	0.5%	1	0.5%	2	0.5%
8	15	RISE	1	0.5%	1	0.5%	2	0.5%
9	16	GOOD	1	0.5%		0.0%	1	0.25%
10	17	PAC	1	0.5%		0.0%	1	0.25%
	18	UAT	1	0.5%		0.0%	1	0.25%
10	**18**		**200**	**100%**	**200**	**100%**	**400**	**100%**
10	**10**	**GNU**	**139**	**69.5%**	**148**	**74.0%**	**287**	**71.8%**

Source: IEC

Why? Because the Constitution grants the president executive power to appoint the cabinet. This removed the proportional representation mooted in the SOI.

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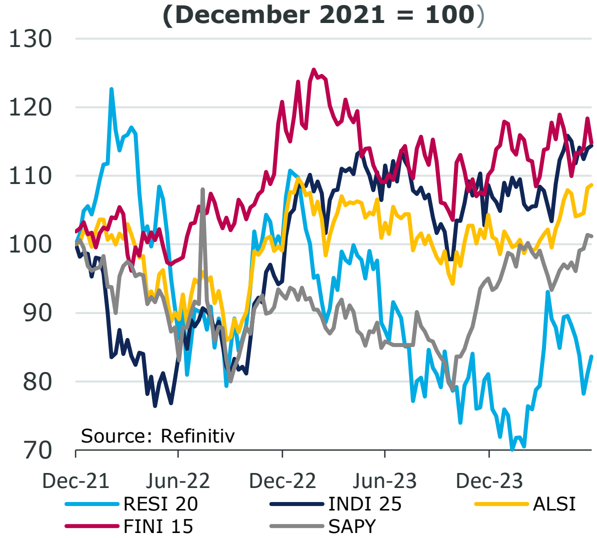
After much negotiating and a threat by the DA to walk away from the GNU, President Ramaphosa has named his cabinet. A long way short of what the DA aimed for, it has secured six ministries and six deputy ministries. None of the DA cabinet portfolios can be considered front-line, but at a deputy level, the DA will have input into the important Finance, Energy, Water, Trade, Industry, and Competition portfolios.

South Africa is at a delicate point in time. The GNU led by President Ramaphosa must not allow polarization to erode the trust in the supremacy of our Constitution, the rule of law, and the Chapter 9 institutions. These institutions provide an important backbone to the bond and stock markets, and our currency. We are over the first hurdle and the market has reacted positively.

ALSI and major JSE indices
(December 2021 = 100)



We are under no illusions as to how difficult it will be to restaff the national, provincial, and municipal offices with competent people where needed. It is also vital to agree on realistic growth policies and to fix and refinance the SOEs, redirect education and health, and root out crime and corruption. For a hundred years to 2014, the JSE ALSI was the best-performing country index in the world. We all know where the country is at, but we still have an incredible foundation and history to build on.

The JSE and the rand have reacted positively to the GNU, happy that the "doomsday scenario" was avoided. In recent years, local investors have tended to underweight local stocks, this has the potential to change. Hopefully, South Africans at all levels will realize that a single party is no longer running the country and will hold individual cabinet ministers accountable.

Year-to-date the rand gold price leads the way (+11.2%), followed by small caps (9.2%), the FINI 15 (+8.2%), SAPY (+8.1%), ALSI (+4.6%), INDI 25 (4.4%), and the RESI 20 (+2.2%). YTD movements in the FINI 15 - down 14% and then up 25.3% for a net gain of 8.1% - show how a positive election outcome can influence the market.

The relatively poor performance of the ALSI in dollars and rands highlights how tough it has been for investors seeking the safety of a diversified or balanced investment portfolio. The GNU outcome has removed much of the bad sentiment around South Africa. Instead of politics interfering with sport, a force for good would be if Rassie, Siya, and Aiden decided to get into politics. Good people can make a difference.

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