

How can the market be cheap if it is at an all-time high?

Why South African equities are still attractively priced

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During 2022, we saw significant movements in global markets, from both an equity and fixed income perspective. Risk-off, fear and uncertainty were the order of the day. On the local side, markets held up relatively well in comparison and it left local investors puzzled. Weak growth, a record amount of loadshedding, high interest rates and an uncertain global backdrop are all factors that should send investors running for the hills, but local seems to remain lekker.

Year-to-date, there has been a healthy rebound in asset prices as inflation numbers are starting to ease, China is reopening and Europe seems to be more resilient than what the market initially expected. The JSE All Share Index reached an all-time high in January 2023, despite the uncertainties our market currently faces. How is that possible you may ask?

A reminder that the stock market and the economy are different

When it comes to distinguishing between the economy and the stock market, the answer is actually very simple as to why they don't always speak the same language. Economic factors are backward-looking and effectively this data reflects events that already happened – like GDP growth, unemployment, manufacturing, etc. The equity market, on the other hand, is forward-looking, taking expected future earnings into account.

Historically, the equity market has been a great discount of information that is readily available and knowable. That's the reason why the market tends to price in information about potential economic events and information (for example an upcoming recession, a credit rating downgrade, etc.) before the event happens.

The other factor that can't be ignored - and one that is especially important in the South African landscape - is that listed companies that sell products offshore are not reliant on how the South African economy performs. These shares are more broadly known as rand hedges.

Whether it's government policy, investor behaviour, or the way we measure the stock market, several factors can cause a disparity between the stock market and the state of the economy at any given moment. The key point to remember is that the stock market is not the economy, but instead, a leading indicator of where investors think the economy will go.

Expectations at record low levels

You can argue that very little went right in 2022. From record-high inflation numbers, hiking interest rates in a weakening economy, an energy crisis, political instability, and a collapse in growth assets, to mass foreign selling of South African assets. The consequence of coming out of an environment like that is that expectations are low, and that's why prices are low.

For Financial Advisors and their Clients

The reality in South Africa is that expectations have been very low for a long time, not just because of the issues faced in 2022. When you have valuations and expectations coming off such a low base, you don't need a lot to go right for you to harvest good returns. You don't need the news to be good. You just need the news to be less bad than what you expected. Then markets can rally.

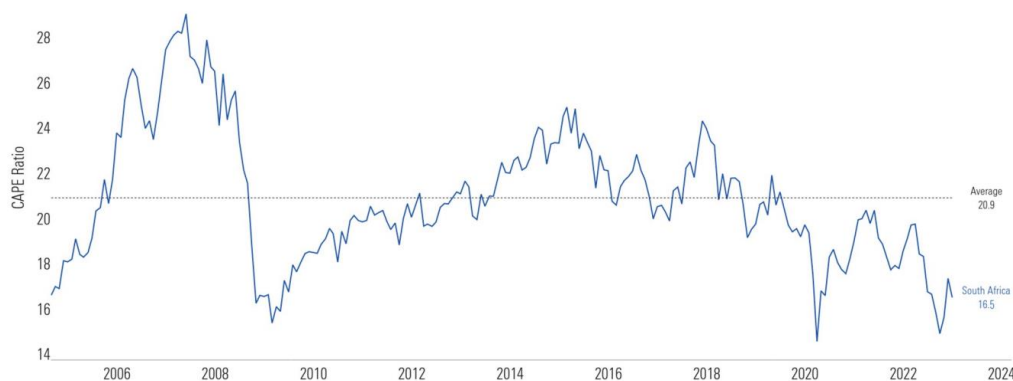
Valuations are cheap

Yes, the JSE All Share Index reached an all-time high earlier this year, passing through 80,000 points. However, the local equity index is a market cap-weighted index, meaning larger companies have a more significant impact on performance, skewing the picture somewhat. There has been a very narrow group of shares driving the market higher.

What you need to look at instead is the Price-to-Earnings (PE) multiple, which looks at what price you pay for every R1 of earnings generated. The chart below shows you the MSCI South Africa Index CAPE ratio (cyclically-adjusted price-to-earnings ratio) over time. The CAPE ratio is a valuation measure that adjusts earnings for inflation over 10 years to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.

What is clear from this visual is that South African equity is currently priced at levels last seen in the Great Financial Crisis in 2008 and after the Covid crash in 2020.

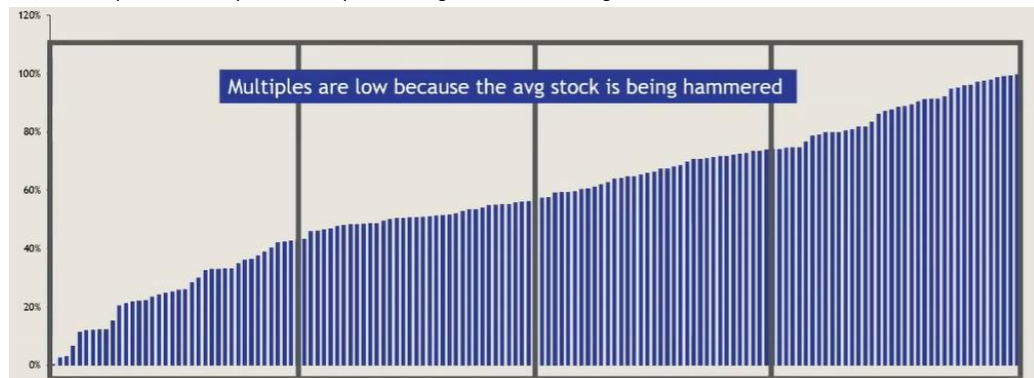
Exhibit 1 | MSCI South Africa Index CAPE ratio



Source: Cleareconomics, MSCI, Barclays. Data as at 31 December 2022. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

Multiples are low because the average stock price was so low

The chart below shows you where each company on the JSE is trading as a percentage of its all-time high, and it is clear that the average stock in our market is trading at levels far below where they have been in the past.

Exhibit 2 | JSE stock price as a percentage of all-time highs

Source: Coronation. Data as at 31 January 2023. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

Dividends are high

The great thing about investing in some South African shares is that your dividends are incredibly healthy. You don't necessarily need share prices to go up significantly or earnings to improve drastically. As an investor, you can essentially just keep collecting the dividends and you will handsomely beat cash. Some of the financial shares are trading at single-digit P/E levels and have dividend yields of around 7.5%. Not a bad deal? Resource companies have also been very kind to investors over the last number of years, distributing most of their profits back to shareholders.

A good combination for future returns

Low prices, low expectations, broad-based pessimism, and low earnings are a combination that typically bodes very well for good future returns, and we would argue that South African equities (from a relative and absolute valuation perspective) are still a very attractive asset class. We remain on weight SA equities, as we can't ignore the headwinds that the asset class faces, but we do believe to a large degree that South African investors will be well compensated for the risk.

We are firm believers in the importance of staying invested through market cycles, even when it feels uncomfortable, and we continue to favour diversification. Patiently allocating to assets that will help you achieve your financial goals should remain key. If you catch yourself getting down about the state of our economy, always remember why you are investing in the first place.



Risk Warnings

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