Asset allocation views - Northstar SCI Managed Fund

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We unpack the thinking behind our asset allocation in the context of the strong run in equity markets since the collapse early in 2020. Despite these gains, the Northstar SCI Managed Fund has its highest exposure to equity in nearly ten years. While developed market valuations appear stretched and the local market is distorted by super-profits in resources, there remains value in SA-Inc stocks and room for further growth in certain sectors globally as corporate earnings rebound.*

Macro environment supportive of the risk trade

Despite extreme turbulence caused by Covid-19 mobility restrictions and their impact on global growth over the past eighteen months, global equities have run hard, reaching record highs. Following the collapse in markets in early 2020, the MSCI World Index delivered five consecutive quarters of positive returns and closed June 2021 14% above pre-Covid levels. To some extent, equity market performance has been correlated to the progress of vaccination campaigns with developed markets broadly performing ahead of emerging markets.

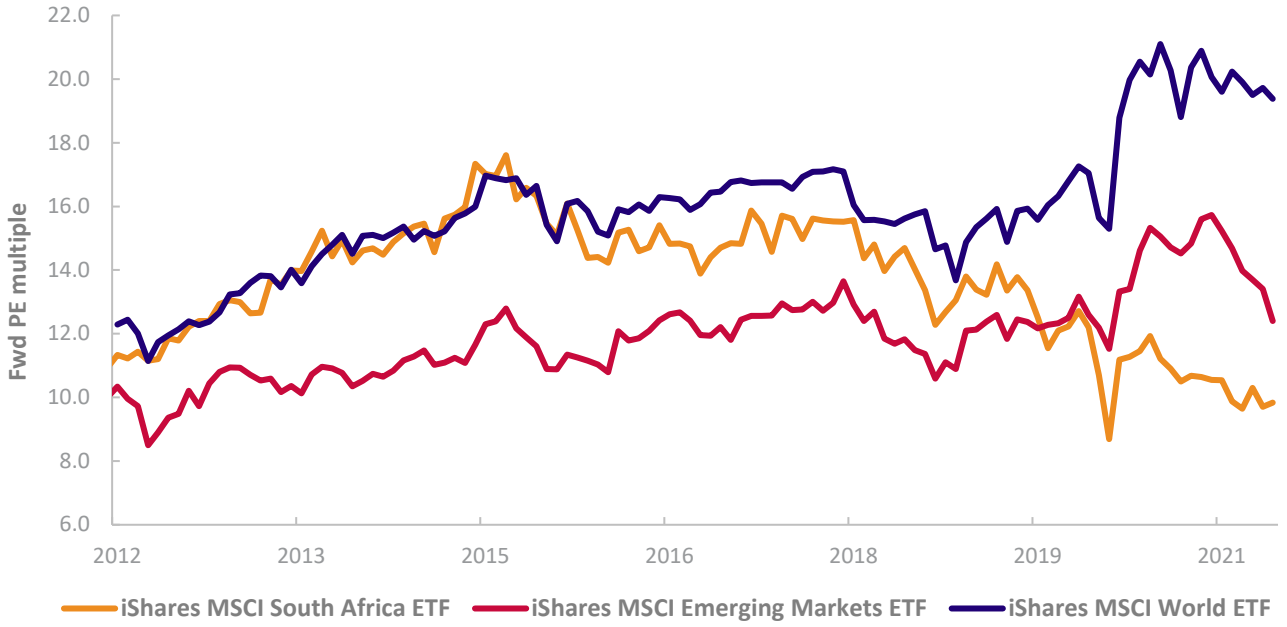
Higher risk assets, and in particular developed market equities, benefitted from highly supportive fiscal and monetary policies as well as a strong rebound in GDP growth as lockdowns were relaxed. US 2021 GDP growth is now expected to exceed 6.1% (Eurozone: 5.1%), while US corporate earnings, following various cycles of positive revisions, are expected to come in 38% higher than 2020 (Eurozone: +48%).

Emerging market equities played catch-up to some extent as vaccine rollout programs started to gain traction. The strong rebound in commodity prices has been the single most important driver of returns for South African equities and the rand. But South Africa has also seen better than expected revenue collection this year, a lower than anticipated budget deficit and improved economic activity, with 2021 GDP expected at 4.0%. This despite significant challenges such as the difficult public sector wage negotiations and the riots following the incarceration of Jacob Zuma. Year to date, the All Share Index is the tenth best performing equity market out of 34 emerging markets.

Local valuations appear attractive but may be distorted

From a valuation perspective, while developed market ratings appear stretched, strong corporate earnings recovery and extremely low bond yields are likely to support high multiples for longer. The S&P 500 and Eurozone 12-month forward PE multiples are trading at a significant premium to their history and to emerging market valuations (Chart 1). In contrast, South African multiples look relatively attractive, having not recovered from their extreme de-rating over the last five years. The local market has benefitted from global growth dynamics over the past year, the strongest beneficiary being the resource index. SA sensitive sectors such as financials, retailers and general industrials have not yet fully repriced, in our opinion, and offer the best opportunity in the market at present.

Chart 1: 12 Month forward PE multiples



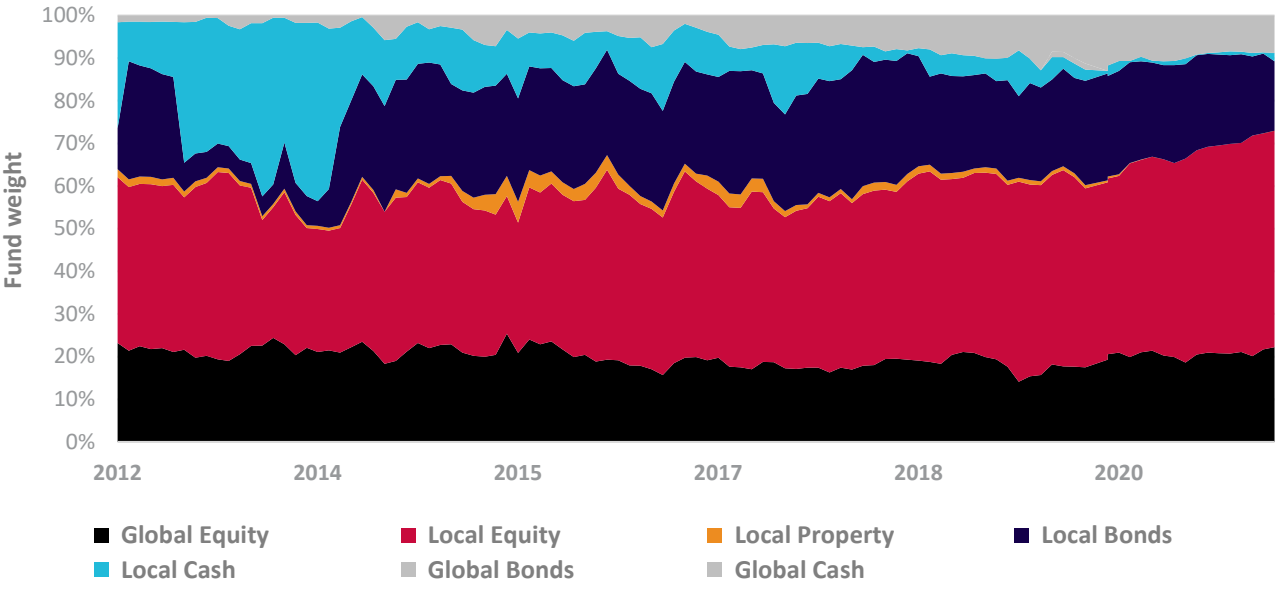
Source: S&P Capital IQ, Northstar AM (Aug 2021)

Opportunities in global cyclicals and quality local assets

Northstar's approach to asset allocation is primarily guided by bottom-up fundamental work which informs a risk-return framework. Over the past five years our cautious stance towards local equities has been broadly justified as structural growth impediments dominated despite increasingly attractive valuations. Offshore, an appreciation of global growth dynamics, accounting changes and the value of intangible assets played crucial roles in our decision to maintain a healthy allocation to global higher risk assets, despite these looking increasingly expensive on traditional valuation metrics such as PE multiples.

More recently, the dislocation in markets caused by Covid-19 in 2020 allowed us to increase exposure to quality local assets that usually trade at premium valuations. Over the past year, we increased exposure to both local and offshore equities guided by attractive valuations. At the end of June 2021, the Northstar SCI Managed Fund had its highest exposure to equity (73%) in almost 10 years (Chart 2).

Chart 2: Northstar SCI Managed Fund equity allocation



Source: S&P Capital IQ, Northstar AM (Aug 2021)

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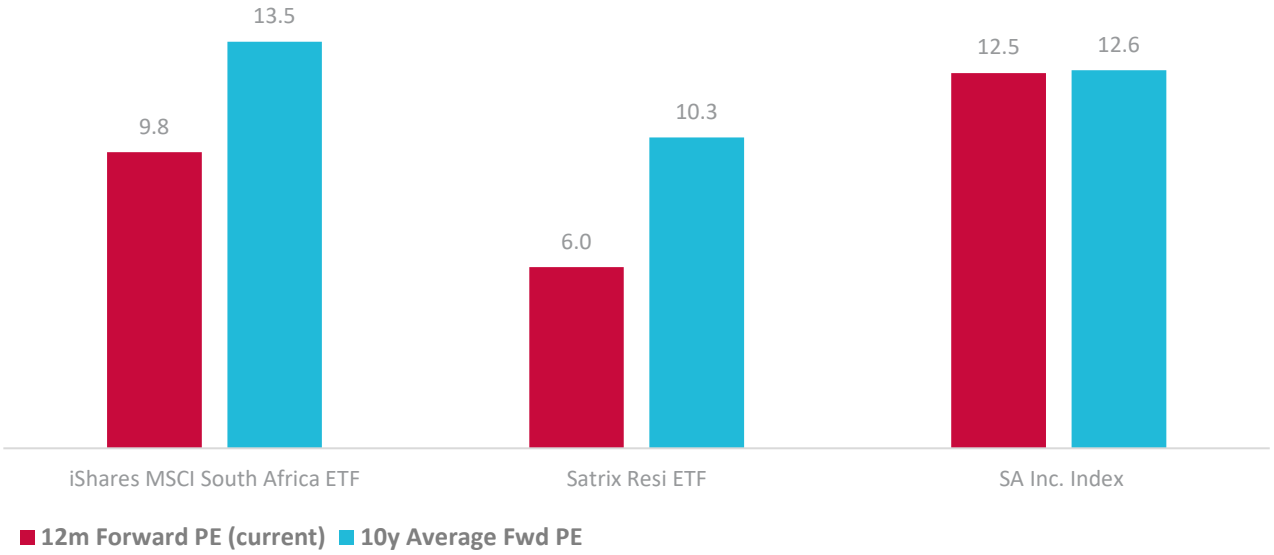
Offshore Assets – Based on our fundamental work and strategic asset allocation model, we are broadly neutral towards offshore equities. While the absolute level of offshore equity in the Fund has not changed significantly since the market correction in early 2020, its composition has, with a healthy component of cyclical stocks introduced that have ultimately benefitted from the recovery in growth. On a forward-looking basis, given significant positive revisions to our corporate growth assumptions and a view of continued supportive global fiscal and monetary policies, we remain constructive on global equities and broadly negative on global bonds.

Local Equity – Although we deem the local market to be fairly cheap, we note that extremely elevated spot commodity prices are causing SA resources to arguably earn super-profits and trade on artificially low PEs thus distorting overall index multiples (Chart 3). An analysis of local equities excluding rand hedges (such as Naspers and Richemont) and resources – the "SA Inc Index" – highlights that while local industrials and financials have re-rated over the past year, normalisation in earnings from current levels is still likely to drive returns higher. We maintain an overall overweight position to SA industrials and financials (excluding SA REITs) and an underweight position in resources in the Fund.

Chart 3: 12 Month forward PE multiples



Source: S&P Capital IQ, Northstar AM (Aug 2021)

Fixed Income – The market correction caused by the Covid-19 pandemic provided us with a rare opportunity to extend duration and increase our exposure to global corporate bonds as credit spreads blew out in early 2020. Having subsequently taken profit and reduced this position earlier this year, our modelling of developed market bonds (including corporate bonds) does not indicate compelling value at present.

On the local fixed income side, we remain constructive on government bonds, which are trading at real yields that are, in our opinion, attractive enough to compensate investors for the inherent vulnerability of the rand and fiscal risks of the South African sovereign. Our base case valuation reveals upside for both short- to mid-duration fixed bonds as well as short-term inflation-linked bonds.

Good returns and a high margin of safety

We believe that the current asset allocation is well-positioned to deliver strong returns. Our bottom-up valuation work indicates that the local stocks in our portfolios have double-digit expected returns, offshore stocks high single-digit potential US dollar returns and the fixed income component should meaningfully outperform inflation, all with a high margin of safety.

*SCI: Sanlam Collective Investments

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