NORTHSTAR
ASSET MANAGEMENT

QUARTER 1, 2022 MARKET REPORT

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Closer to the truth

What made us reduce global equities and buy SA bonds in Q4, 2021?

Mark Seymour, Director Fixed Income

Global diversification can open up opportunities and ameliorates risks. However, the price paid is the most important determinant of future returns, making it critical to avoid one-dimensional strategies and myopic linear thinking. We unpack the warning signs we saw in global equities and opportunities in SA bonds that led to Northstar taking a position in opposition to the herd.

Northstar believes firmly in diversifying capital globally, particularly accounting for the sizable opportunity set and risk ameliorating benefits that accrue through this approach.

Notwithstanding this however, our investment philosophy and process pivot off mispricing opportunities, both in terms of capitalising on undervalued securities but equally so, circumventing overpriced assets.

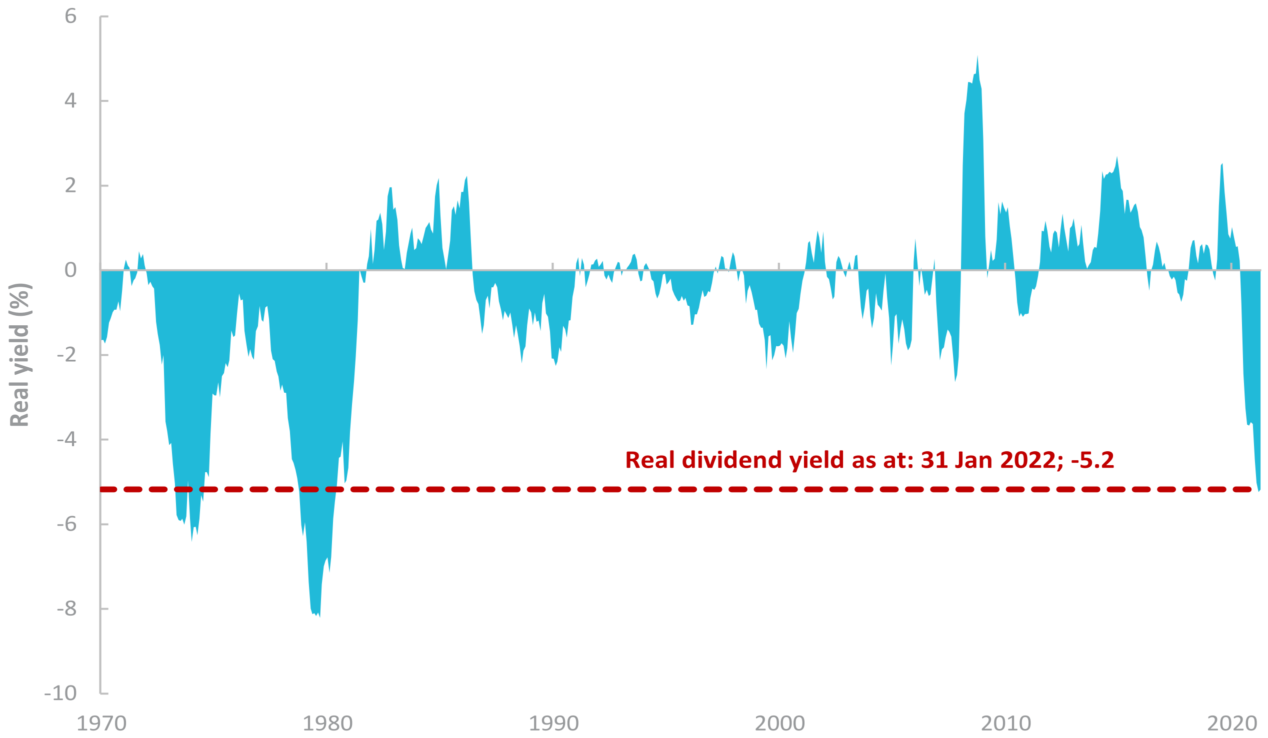
With this in mind, our asset allocation framework (constructed from our bottom-up return matrix for all asset classes) instructed a meaningful adjustment in Q4, 2021, to reduce global equities and purchase South African bonds. This article does not explore Northstar's bottom-up research inputs, but instead depicts some higher-level linkages that we believe, rationalise this action.

This is of course a two-sided discussion – we will start by showing the risk indicators that were flashing red for global equities and then demonstrate the opportunity that presented for domestic bonds late last year.

Dow Jones dividend yield turns negative in real terms

We understand that Covid prevented many corporations from paying dividends and in 2022, companies that did not pay dividends in 2021, could do so going forward if we exit the pandemic. This does distort the picture that follows. But the facts remain, the real dividend yield on the Dow Jones at the end of Q3 2021 was -4.48%. Only twice over 50 years, both of which occurred in the 1970's has the yield been this low – a period characterised by a sideways moving market for a decade.

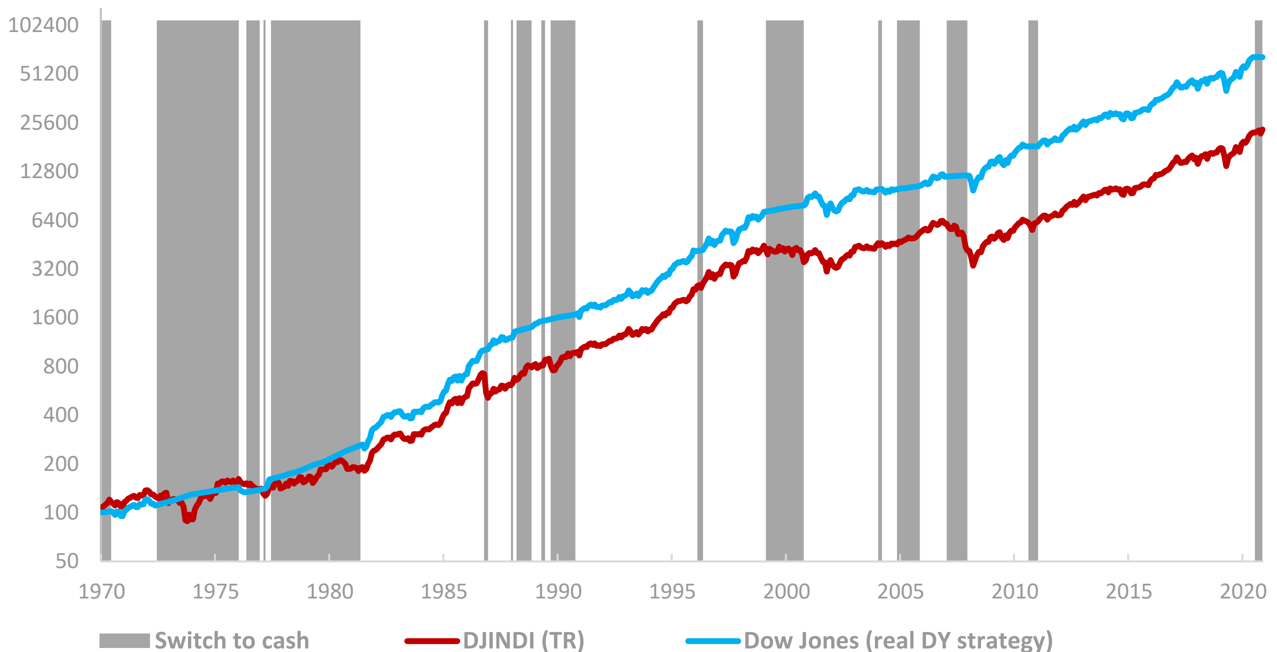
Chart 1: Dow Jones real dividend yield (1970 to 2022)



Source: Bloomberg, Iress & Northstar (Date: 31 Jan 2022)

In our second chart, we compare the total returns from the Dow Jones versus a strategy where an investor exits the market when the real yield drops below -1% and enters the market when it heads higher than -1%. The total annualised return of the Dow Jones since October 1970 to the end of October 2021 is 11.2%, with a standard deviation of 15.1%. For the dividend yield strategy described above, the annualised return is 13.5% with a standard deviation of 11.3%.

Chart 2: Dow Jones total return index vs. strategy incorporating switching to cash when real DY falls below -1%

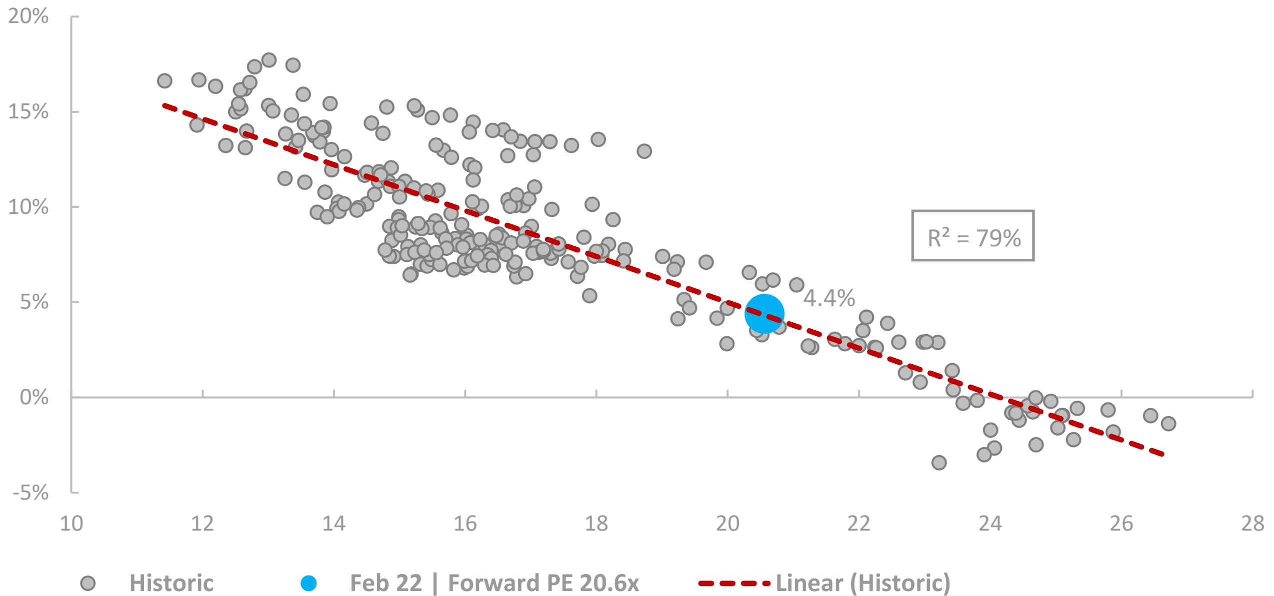


Source: Bloomberg, Iress & Northstar (Date: 31 Jan 2022)

S&P forward P/E against prospective market returns

Our third chart compares the forward P/E (including market's earnings for the following 12 months) against prospective returns. The current forward P/E of the S&P 500 is 20.6 times, historically, off this forward P/E the market generated returns on a 10 year basis of 4.4% annualized. Even assuming 2% inflation, a real return of 2.4% annualized does not compare favourably to long-term real returns from the S&P over the same period (1990 to present), of 8.7%.

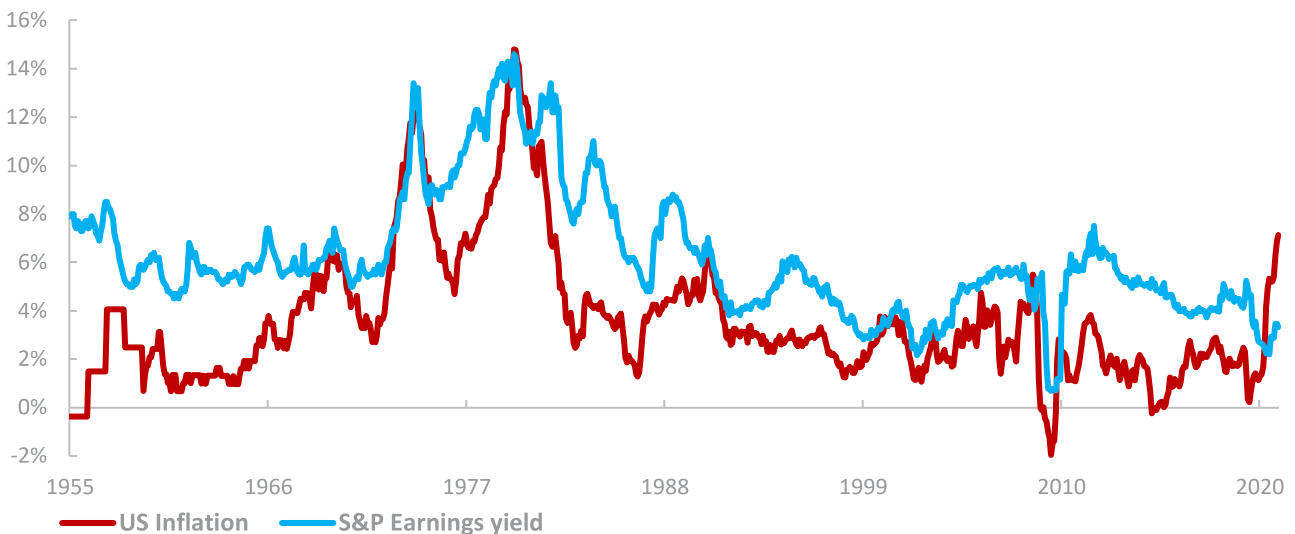
Chart 3: Forward P/E and subsequent 10-year annualised returns S&P 500 Total Return Index



Source: Bloomberg & Northstar (Date: 2 Feb 2022)

Our fourth chart on US market valuation compares the earnings yield of the market against inflation. Historically, as inflation rose, the earnings yield rose in sympathy, in so doing, compensating investors through a higher inflation-adjusted yield. Presently, the earnings yield is negative in real terms to the tune of 4.1%. The market has to believe that inflation is dropping to justify this situation, alternatively earnings must rise rapidly or stock prices must adjust lower. It is probable that a combination of all of these outcomes is likely.

Chart 4: Earnings yield follows inflation



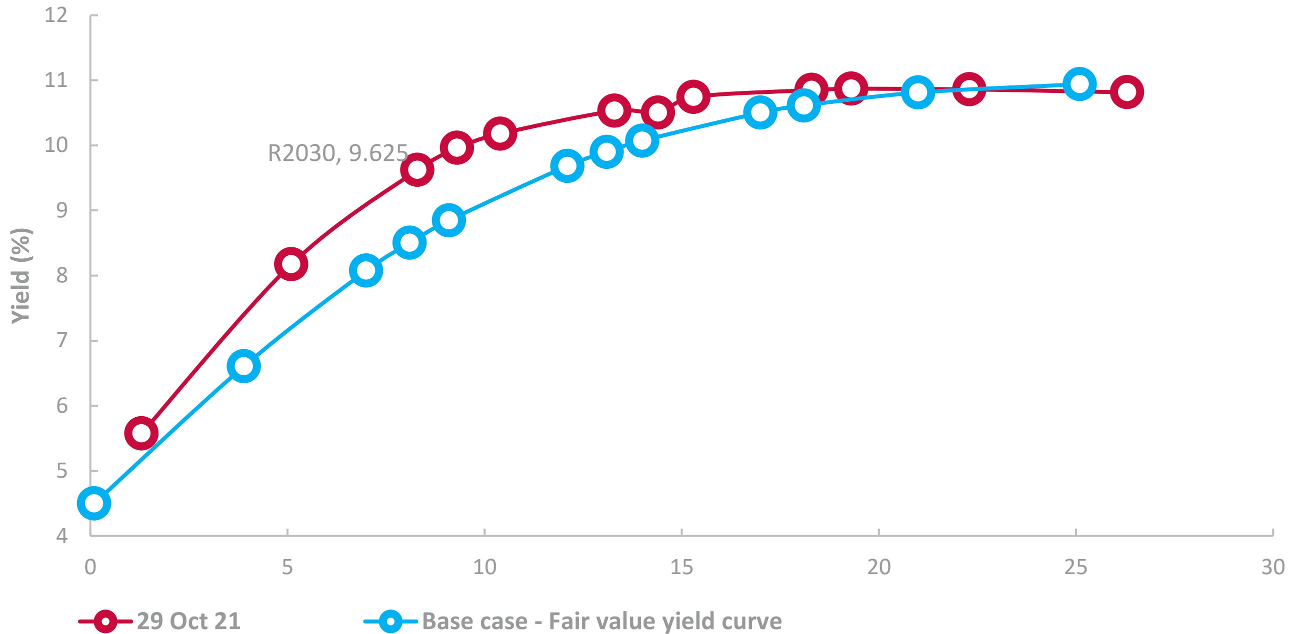
Source: Iress & Northstar (Date: 31 Jan 2022)

SA Bonds

We now switch to the opportunity that presented itself during Q3 2021 – SA bonds.

The R2030 that matures on 31 January 2030 was yielding 9.63% at the time and by our estimates, offered a 1-year return of between 11%, under a bear case scenario, to 17.5%, our base case scenario and 24%, being our bull case - these projections incorporated 75bps of SARB hikes over a year.

Chart 5: SA Government yield curve



Source: JSE & Northstar (Date: 29 Oct 2021)

Conclusion

We conclude with the message that one dimensional strategies and myopic linear thinking propels herd mentality. The perceived safety of offshore investing by South Africans has to some degree ignored the key principle that the price you pay is the most important determinant of future returns.

Juxtaposed against this, high yields and a marginally better fiscal position than most of us had imagined during the height of Covid meant that SA bonds offered abnormally high returns for the risks being taken.

Myth busters

Adrian Clayton, CIO

We test some of the dangerous hard-coded market narratives against the data and find them wanting – specifically the influence of interest rates and the usefulness of value vs growth investing styles at different points in the interest rate cycle. Along the way, we confirm the single factor that is actually effective in predicting outperformance or underperformance.

The market has a communal mind. Frequently a narrative, an idea or concept is latched onto by investors, hard coded and accepted as gospel. Presently, examples include:

1. The idea that higher interest rates will catalyse equity weakness;
2. Growth/quality has been a fad and it is time to pivot into value, which is a better long-term performance metric.
3. Then there is the thesis that value outperforms growth/quality when interest rates rise.

Being natural sceptics, we used a data-focused approach to test these potential “myths”.

Stock markets rise as rates fall and fall as rates rise – myth or fact?

We analysed 10 hiking and 10 declining USD rate cycles dating back to the 1950’s and our findings are as follows:

- There is an unexpectedly long lag and during the initial stages of a rising cycle generally, markets continue to head higher for at least a year, before performing poorly.
- The same lag, up to two years, exists when rates are cut.

Economies and markets have natural momentum, be it positive or negative, and this lasts longer than expected when interest rates are changed. Although broadly similar each cycle differs uniquely based on the relative levels of equity valuations.

So interest rates are negative for equity prices, BUT we emphasize that this is not always immediate and in the short-term (up to two years) equity prices often move in the opposite direction to what is expected.

Growth/Quality is a fad – pivot to Value – myth or fact?

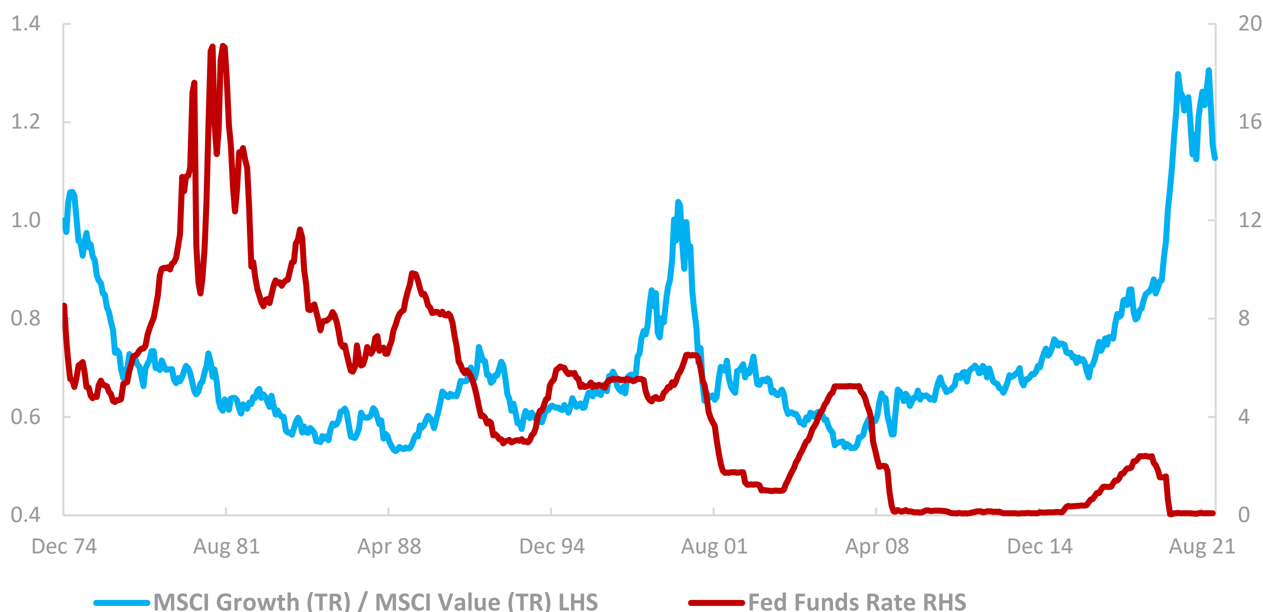
Chart 6 compares growth against value over the past 45 years. Growth outperforms when the blue line on the chart rises. We note four distinct periods, showing which style outperformed.

Period	Style outperformance
1974 to mid 1988	Value
Mid-1988 to early 2000	Growth
Early 2000 to mid-2007	Value
Mid-2007 to 2020	Growth

Out of interest, both styles pretty much returned the same quantum from December 1974 to February 2020. Both styles win when they start off cheap. Growth’s well known outperformance from 2007 to 2020 created a buying opportunity for value. It is impossible to forecast the duration of the current value cycle, suffice to say that

historically once a style gains momentum it tends to last for a long time. Our point is that there is no quantitative evidence to point to one style being superior to the other.

Chart 6: Growth/Value vs Fed Funds Rate



Source: Source: Inet and Northstar

Value outperforms growth during rising interest rates cycles – myth or fact?

The theory behind front loaded cash flow being worth more to investors in a rising interest rate environment makes sense. We intuitively buy the concept that more mature companies that we view as value stocks should offer this.

In practice though, there is no conclusive evidence that value outperforms growth/quality companies during interest rate rising cycles. The definition of a rate cycle is key and we have focused our attention on the longer, more established US cycles stretching back to the early 1970's. With reference to our chart, we note four significant interest rising periods and indicate which style outperformed:

Interest Rising Period	Style outperformance
1977 to 1981	Massive increasing cycle Value
1986 to 1988	Growth
1993 to 2000	Growth
2004 to 2017	Value
2015 to 2019	Value outperformed for the first 15 months and then Growth accelerated and outperformend

It is evident that there appears no direct correlation between rising interest rate cycles and value outperforming.

In summary, our analysis leads us to the view that hard coded narratives are dangerous.

Although rising rates in the long-term are not great for markets and declining rates are market friendly, lags exist in the short term once interest rate cycles start to change.

One style is not necessarily better than the other. It is our contention that their relative pricing or valuation is key to initiating an outperforming or underperforming cycle. On this point, growth/quality became expensive in late 2020 and value was relatively cheap.

Finally, the view that higher rates always favour value stocks appears unfounded and we struggle to see proof of this in the numbers.

Shaping opportunities in a world of extreme asset valuations

Matt Bertram, Financial Director and COO

What are the building blocks for successful investments? This article breaks down five of the most important variables that influence where and when to invest, lays out where the market currently is relative to prior trends, explains how these are likely to play out and shows where Northstar sees opportunities.

When deciding to spend money to invest, only three things really matter:

1. Benefit of the asset, for example its future cash generative abilities.
2. Its potential for growth.
3. Identifying an appropriate discount rate. This is used to present value the future potential of any asset allowing for comparison of options.

To be successful, asset managers must apply this technical approach together with a deep knowledge of the broader macro vectors that both influence and drive the "animal spirits" of markets. This is a huge topic, which we have tried to contain and make relevant for today, under the following headings:

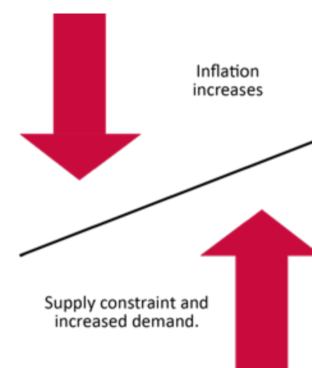
1. Inflation
2. Interest rates
3. Debt
4. Demographics
5. Inequality, regulations

We hope to provide some insights into the variables that influence where and when to invest through time.

1. Inflation – what goes up and never comes down!

Inflation exists in the nexus of supply and demand, both of which are currently working in tandem. Some examples of inflationary pressures, amongst many, are:

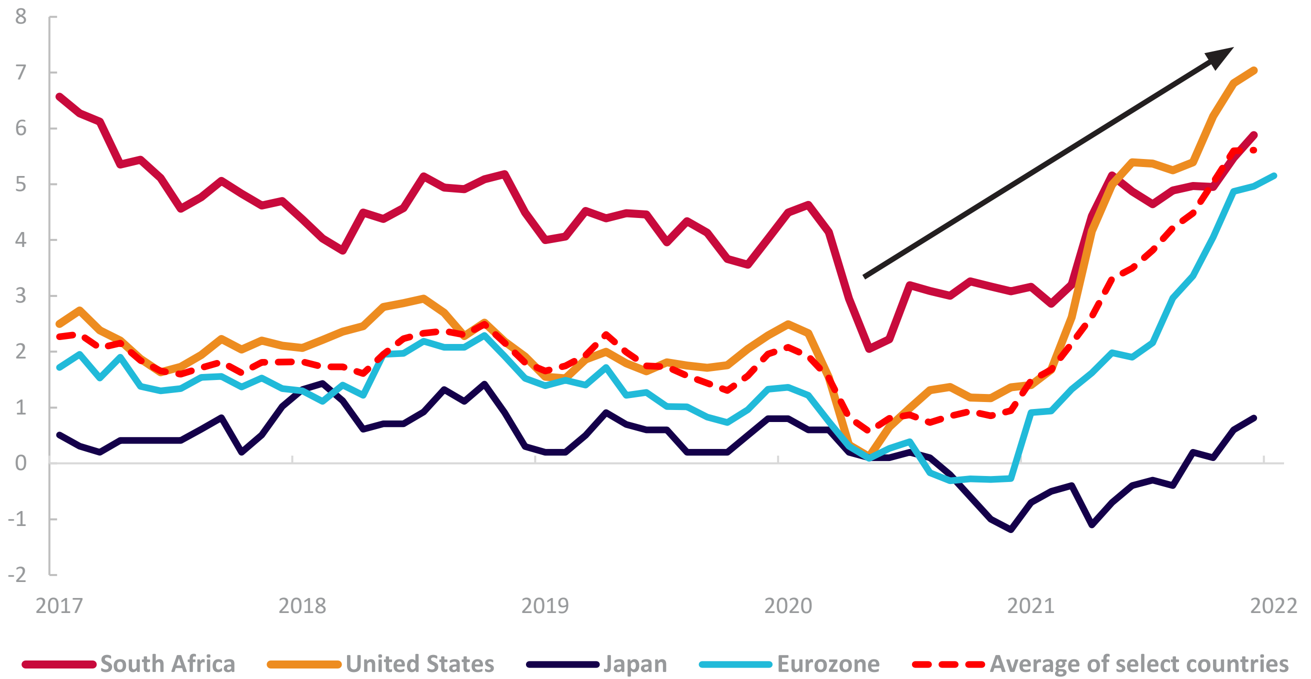
- **Supply constraints:** e.g. the excess stock of cars in the US was 77k on 31 December 2021 significantly lower that the rolling average of 1 million.
- **Demand:** pre-Covid, 41% of US 25–64-year-olds could not cover an unexpected USD400 expense, after government Covid grants, now this is just 33%.



If governments spend and money supply is allocated efficiently to money generating assets, out of control inflation should not be the result. However, this is perfection, and it is worth noting that the US fiscal deficit increased to USD3.12 trillion in 2020 from USD1.4 trillion in 2008. The Fed and the Fiscus (Washington) worked in tandem with

the Fed increasing money supply monthly by USD120 billion in 2021. Now after years of disinflation (declining rates of price increases), inflation has followed as illustrated in the chart below.

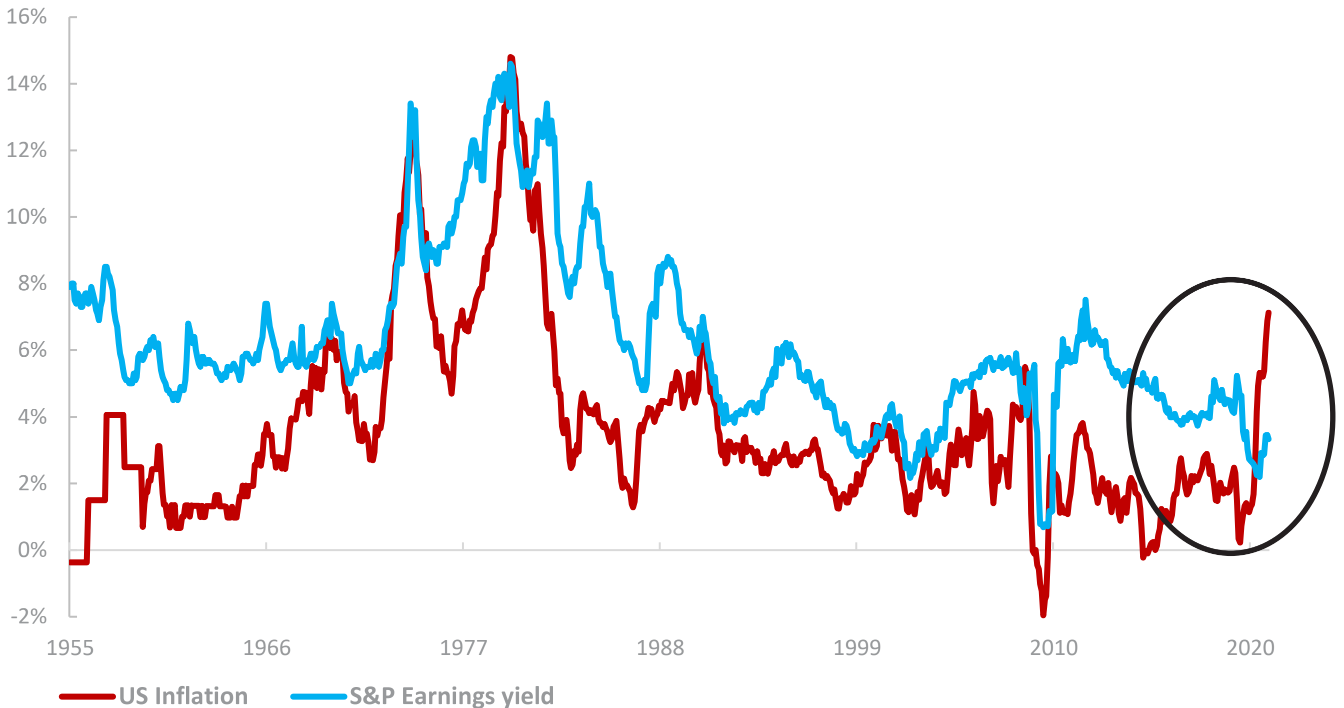
Chart 7: Inflation YoY%



Source: Capital IQ

Our next chart shows the direct effect of inflation for investors. When earnings yields turn negative in real terms (this is where the yield that the market provides drops below inflation), investors are no longer being compensated to hold equities. Either inflation must drop back or share prices must fall to incentivise security owners with higher yields or companies must earn more (grow) to ensure investors are rewarded for owning shares.

Chart 8: Earnings yields follow inflation – Inflation is rising



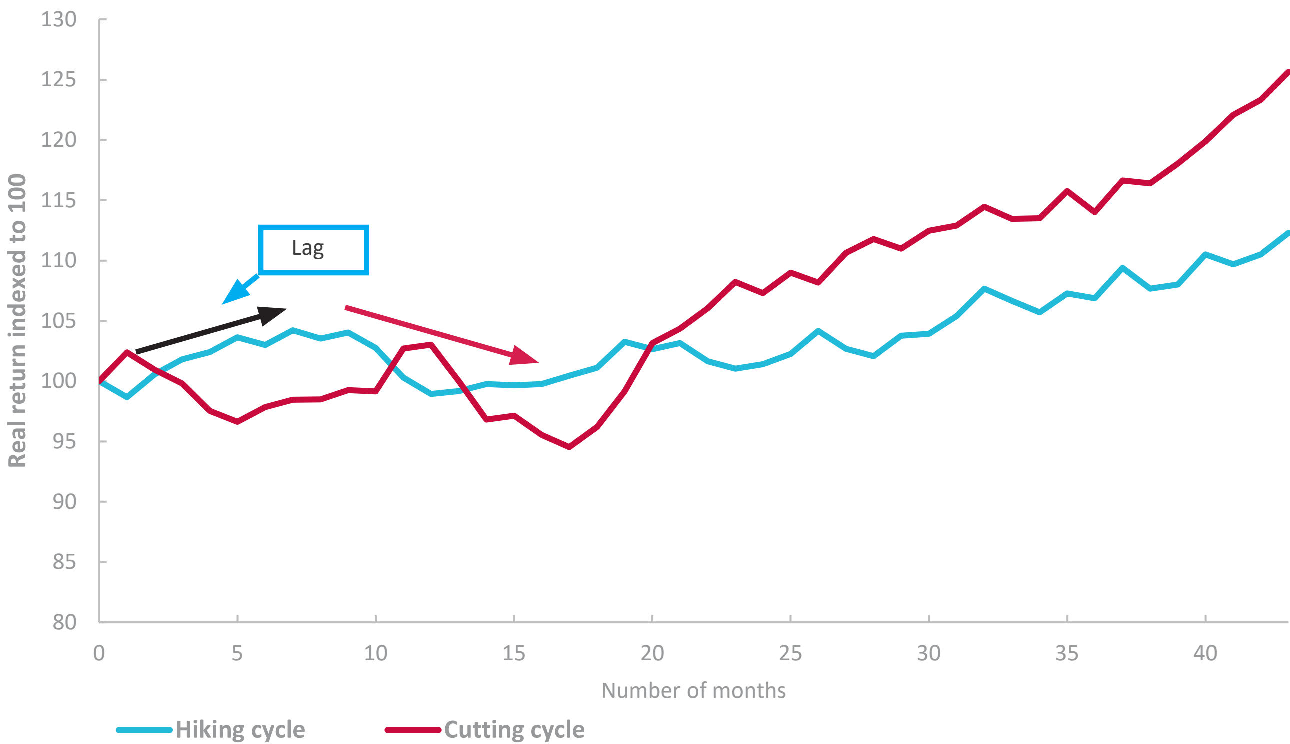
Source: Iress

2. Interest rates – tame the beast!

"Interest rates are to the value of assets what gravity is to matter, if I could reduce gravity's pull by about 80%, I'd be in the Tokyo Olympics jumping." Warren Buffett (May 2021). When interest rates are low asset prices are unconstrained by gravity and climb, which they did in 2020 and 2021. When inflation spikes begin to emerge, the Fed generally starts to make noises about increasing interest rates and in January 2022, Jerome Powell stated that *"I think there's quite a bit of room to raise interest rates without threatening the labor market."*

Naturally interest rate changes impact returns, however there is a lag-effect. The chart below looks at the real returns following 10 interest rate cutting and hiking cycles over the past 50 years. As interest rates are cut one would expect an increase in the real return, however, the interest rate cutting cycle takes time to assist the market as the negative momentum of the economy and market stay in place for a while before the relief from lower interest rates set in. Similarly, a hiking cycle takes time to bite real returns – the momentum of a buoyant market remains intact for many months before interest rates slow the system down. We believe this is important as we feel that investors are too complacent considering the Fed's intention to increase interest rates this year.

Chart 9: S&P 500 – Average real return post change in Fed funds rate (1960 to 2021)

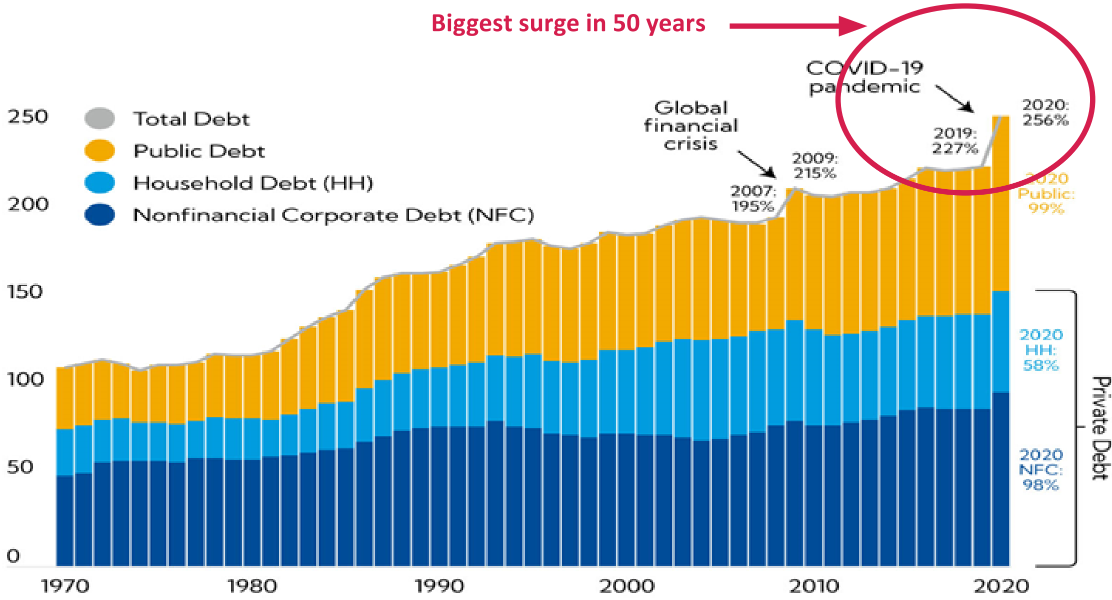


Source: Iress and Northstar

3. Debt – the balance sheet enemy hidden in plain sight

Debt is surging and when that happens every 10 years or so, a financial crisis tends to follow, albeit not always in the timeframe expected. The following IMF chart shows just how much of an impact Covid has had on debt levels, with the GFC a decade earlier making for a sobering comparison.

Chart 10: Global debt levels



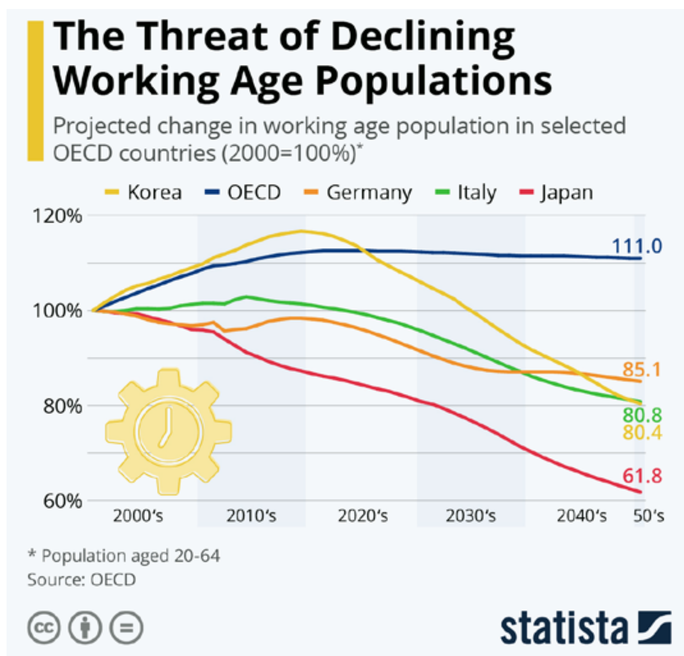
Sources: IMF Global Debt Database and IMF staff calculations.
Note: The estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars.

4. Demographics – the difficulty of trying to grow with the weight of debt

A vector that tightens like a vice as the decades pass. Population size and capability are the two key drivers of economic growth. It is a well-known fact that population numbers are on the decline in developed markets.

- A study has shown that when the 50–60-year-old cohort (number of people in that age group of the population) drops below the level of 40 to 50 year olds, GDP starts to decline. In addition, as retirees make up more of a population, they start liquidating their capital into cash, also acting as a drag on markets.
- Immigration has to an extent counteracted declining population growth in developed countries but working age populations are declining. The Japanese population is expected to decline 40% between 2020 and 2100 (126 million to 76 million), as an example. The Statista chart below shows the rapidity of the decline. Interestingly the US is one of the only developed countries still growing (i.e. birthrate of more than two per couple).

Chart 11: Developed market demographics



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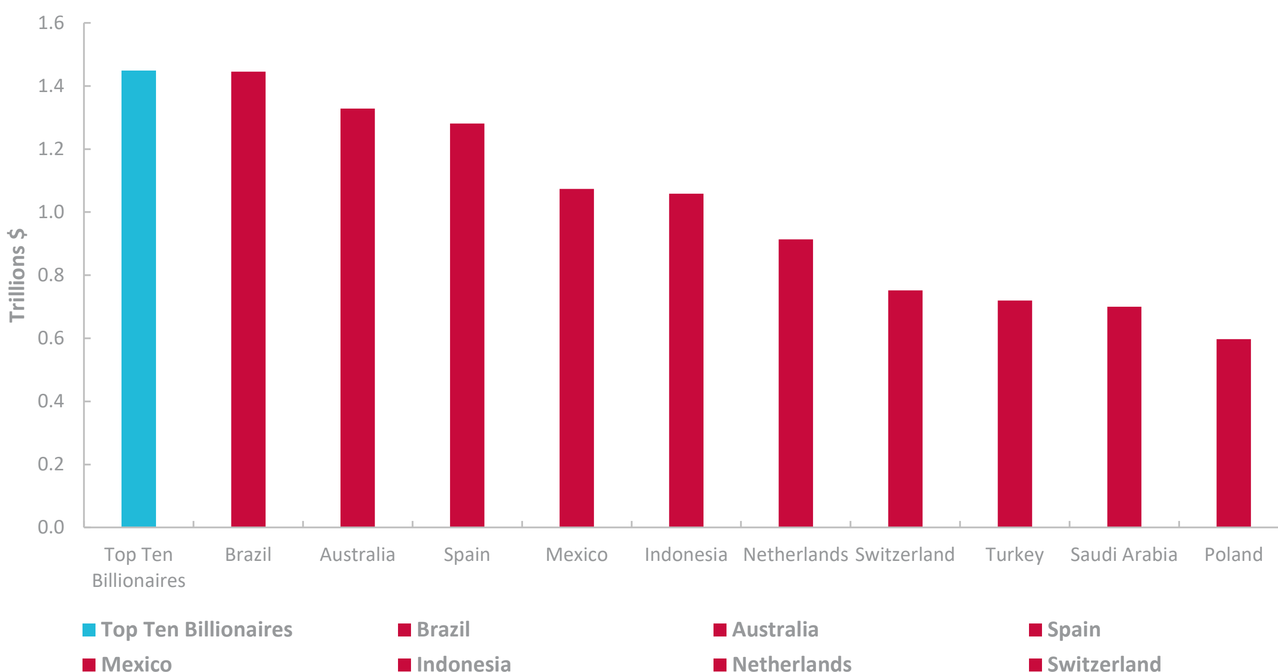
- Globally a middle class is arising in emerging markets (EM), which is encouraging.
- Does this mean that EMs are the place to invest? China's rapid growth is a prime example, however caution is required. Despite Africa growing its population at a pace that far outpaces developed markets, implying that it has the potential to be the engine of global GDP growth for the next century, the top 10 countries of the past 100 years remain pretty much the same today and Africa has never been in that grouping. African countries have growing populations but their GDP growth fails to match their demographic advantage, capacity concerns are a fundamental issue, South Africa being a prime example, as noted in the budget by Minister Gondongwana.

5. Inequality driving regulation – restoring balance

Common prosperity in China, wealth tax proposals in the US and the multitude of labour regulations in SA are all attempting to restore balance against skewed wealth. Whilst we are all aware that SA has a terrible Gini coefficient(the ratio that represents the difference in wealth between the rich and the poor), this is a global challenge, and the chart below speaks for itself.

Chart 12: Wealth of the top 10 Global billionaires relative to country GDP levels



Sources: IPS analysis of Forbes' live billionaire list and World Bank: UN Population estimates (as of 18 Jan 2022) versus select country GDPs, 2020

There are very real-world implications to these governmental initiatives or wealth interventions on asset prices in the market, Tencent (the driver of Naspers, Prosus) being a good example. Its share price decreased 40% between February 2021 and December 2021.

Valuation and conclusion – perfection ahead?

Markets appear to be hoping for a smooth, open highway of growth. The car is running well, but potentially starting to overheat and the traffic police (Central banks) are out to slow things down:

- S&P margins, which are an important element to the Earnings (E) component of the Share Price (P)/E equation, are at all-time highs. Whilst technology and efficiency have helped improve the profitability of US firms, given time competition will extract its toll.
- Current low real yields tend also to predicate market corrections historically.
- The Cyclically (C) Adjusted (A) P/E ratio (CAPE) attempts to smooth out the basic P/E ratio, which exists only at one point in time. The CAPE creates a longer-term rolling ratio, smoothing out for example the base effects of depressed earnings followed by profit bounce backs. The S&P CAPE is not too far off 2000 highs.

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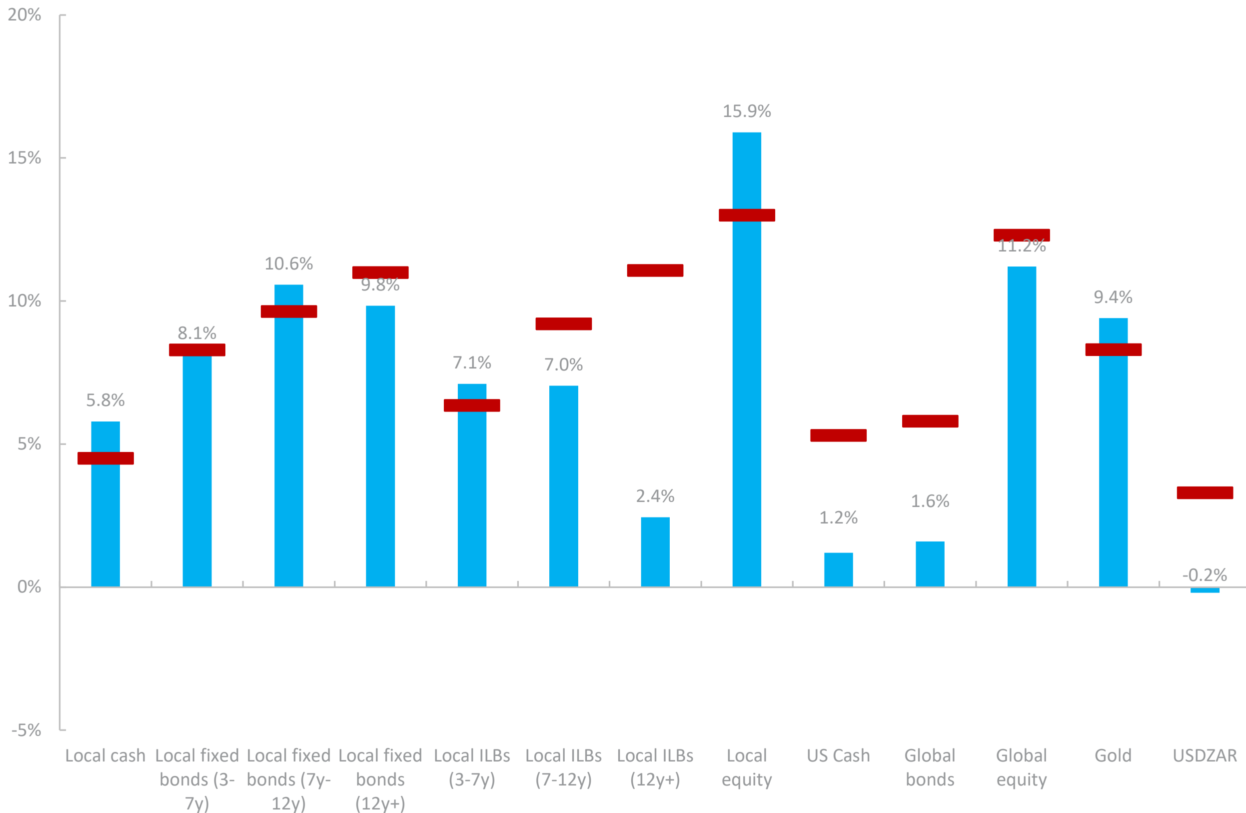
These assessments are certainly useful clear warning flags about markets and stocks in general. How do we navigate these markets where there is potentially nowhere else to invest (TINA)?

- Scan across bourses globally and seek to identify opportunities in areas that that are relatively better priced.
- Understand the relative valuations across different asset classes and invest in those where the risk versus reward balance is in our favour – see our framework below indicating which assets are meeting their required return hurdles (in red).
- Be cautious to simply buy an index, particularly when markets are high. Indices are an average, which is not perfect, for example most people think they are above average. Some companies will be overvalued and some undervalued – undertaking consistent accurate research assists to avoid overvalued companies and directs us to better valued businesses.
- Invest in quality companies with strong balance sheets which are able to withstand inflation and interest rate hikes and that have established future cashflows that are not all weighted in the future.

Currently our funds are positioned according to the following chart. For example, in our Northstar SCI Managed Fund, towards the end of last year, we reduced offshore equities and increased SA bonds. Following the recent boring but safe SA budget, we hope that investors will better appreciate SA bonds – we believe that these will generate strong returns for us.

Chart 13: Expected returns vs hurdle rates



Source: Northstar, Iress, JSE, Capital IQ & Bloomberg

Events such as Covid and currently the Ukraine crisis can throw spanners in the works, but having a long-term strategic plan and using quantitative and qualitative tools to constantly assess the many variables that shape the investing ecosystem, ensures consistent long-term outcomes for patient investors.

Meet the team

Kiara Sukdao
Business Development Consultant

When did your interest in financial markets start?
My interest started in high school while studying economics which is when I realised the absolute complexity of financial markets.

What did you study and why?
I studied a Bachelor of Business Science specialising in Finance because I wanted to gain a deeper knowledge of the investment industry.

What do you think equips you to do this job properly?
My eye for detail ensures a high standard of output and my research capabilities allow me to navigate the various components of asset management.

What do you love about investing?
I like the idea that investors seek to shape the world we live in through their investment decisions to allocate capital to entities or not.

What do you find the most challenging part of your role to be?
No two tasks are the same, which means that they require different solutions and out of the box thinking to get to the best outcome.

Why do you think clients will do well at Northstar?
We follow a sound investment strategy, investing in high quality companies that are reasonably priced, which provides long term value creation for our clients.

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