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STAND POINT

It's time to stock up

STANLIB

STAND POINT

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From our StandPoint

A note from our Head of Retail Distribution, **Alan Ehret**

The rains came in October and the jacaranda trees duly bloomed, carpeting the streets of suburban Johannesburg in purple. The turning of the seasons reassures us that all things shall pass, which feels like good news after the year we have had. The world feels a more uncertain place than it has for years, and investors are asking themselves whether they need to learn new habits to grow and protect their wealth going forward.

In the twelve years following the Global Financial Crisis of 2008, asset valuations grew fat on a diet of historically low interest rates. Markets were rudely awoken from this happy state in early 2020: since then, they have had to digest the accelerated 'bust-boom' of the COVID-19 pandemic followed by governments' massive fiscal and monetary response. This largesse was a vote-winner and drove global equity markets to new highs, but sowed the seeds of future volatility: demand has recovered faster than supply chains which have been further disrupted by the war in the Ukraine. Now, the persistence of inflation appears to hold the key to the trajectory of interest rates and the depth and length of the imminent recession.

An investor's emotional state is often visualised as a needle which swings between greed and fear. This might sound ungenerous but has some truth to it; investors are no less vulnerable to behavioural bias than anyone else. We may confidently set out a long-term investment strategy in the sure knowledge that markets have always generated wealth over a long enough timeline, but when the screens are bathed in red, our evolutionary brain says 'run'. As professional stewards of our clients' wealth it is our job to help them stay the course when volatility is keeping them up at night.

Investors will and should have short-term financial goals and need to consider tactical strategies to reach these, but long-term wealth creation demands a long-term investment strategy and the poise to stay with it when markets temporarily move against us. Allowing ourselves to be whipsawed by our emotions spells certain death for investment returns: human beings' innate algorithm buys high and sells low. In this edition of STANDPOINT, we aim to look beyond the challenges of today to the opportunities of tomorrow.

Victor Mphaphuli, STANLIB's Head of Fixed Income, sees value in South African government bonds after a big sell-off despite improving credit dynamics and the prospect of fading inflation.

STANLIB's Data Analytics team provides our portfolio managers with behavioural finance tools to overview their investment strategies. The team has contributed an excellent user's guide to the cognitive frailties that stalk every investor's process; essential reading in volatile times.

John Bilton, Head of Investment Strategy at J.P. Morgan Asset Management, shares deep and insightful research from his team in the 27th annual edition of their Long-Term Capital Market Assumptions. Encouragingly lower valuations and higher yields mean that markets today offer the best potential long-term returns since 2010. After a year of turmoil and the unwind of market dislocations, asset return forecasts move close to their long-term equilibrium – effectively 'back to par'.

Taking a more local view, STANLIB's Chief Economist, Kevin Lings, shares his thoughts on the outlook for South Africa. He sees better days ahead for the SA economy as key structural reforms are implemented, interest rates fall and the global economy recovers in 2024.

STANLIB is increasingly focused on the broader implications for South Africa of our investing activities. Johan Marnewick, STANLIB's Head of Credit Alternatives, explains how private market investors have the capital, skills, and investment horizons to play a crucial role in (re)building South Africa.

Today's economic and market environment is complex and unstable; long-term investors must recommit to the tried and tested principles of investing while looking beyond today's uncertainties. We wish you a well-earned rest over the holidays and look forward to reconnecting in 2023.

Yours sincerely,

Alan Ehret

STAND POINT

Developments shaping the South African economy going forward

AT A GLANCE

SA's economic performance could improve over the next few years

Abating inflationary pressure is expected to lead to rate cuts

The President's 'Energy Action Plan' should enable SA to achieve energy security

Fixed investment growth is expected to jump through public-private partnerships (PPPs)

Kevin Lings,
STANLIB Chief Economist

The South African economy is facing a range of cyclical as well as structural impediments to growth, and they are being amplified by a weakening global economic environment. Fortunately, the implementation of key structural reforms, combined with lower interest rates and a global economic upswing in 2024, could start to improve SA's economic performance over the next few years.

Globally, there has been a significant slowdown in economic activity. In the October 2022 World Economic Outlook (WEO), the International Monetary Fund (IMF) highlighted that the global economy continues to face three significant challenges: Russia's invasion of Ukraine; a cost-of-living crisis caused by persistent and broadening inflation pressures; and a slowdown in China, amid frequent lockdowns under its zero-Covid policy and the ongoing weakening of its vital property sector.

Given these challenges, the IMF revised down its global growth forecast for 2023 to 2.7%. This compares with an estimate of 2.9% in July 2022 and 3.6% in April 2022. The long-term average growth rate for the world economy is around 3.4%. More than a third of the global economy is forecast to decline this year or next, while the three largest economies — the US, EU and China — will continue to stall.

Persistent and broadening inflation pressures have triggered a rapid and synchronised tightening of monetary conditions, along with a powerful appreciation of the US dollar against most other currencies.

The sharp appreciation of the dollar adds significantly to price pressures in many smaller economies, including SA. Under these circumstances, global inflation is forecast to rise from 4.7% in 2021 to 8.8% in 2022, but to decline to 6.5% in 2023 and 4.1% by 2024, partly because of higher global interest rates.

Unfortunately, the balance of risks is tilted firmly to the downside, with about a 25% chance that global GDP growth in 2023 will fall below 2%. Avoiding these risks requires monetary policy to remain on track to restore price stability, while fiscal policy needs to either complement monetary policy or, at least, remain neutral.

The South African economy remains constrained by structural impediments

SA has not been spared from these developments. The country is also battling with elevated inflation and rising interest rates, in an environment of extremely low economic growth amid both domestic and international developments.

While SA's price pressures probably peaked in July, the inflation rate is still expected to remain above 7% for the remainder of 2022, forcing the Reserve Bank to continue increasing interest rates. In the short term, the Reserve Bank cannot afford to be complacent in guarding against a broad-based deepening of inflationary pressure. Therefore, it seems reasonable to assume that it will continue to hike rates into early 2023.

From a growth perspective, SA's underlying performance has been weak, despite an ongoing recovery from the Covid-19 pandemic. In the second quarter of 2022, SA's GDP declined by -0.7% quarter-on-quarter (seasonally adjusted but not annualised). This latest decline was broad-based, including declines in mining, manufacturing, retail, construction, and agriculture.

Although the floods in KwaZulu-Natal and increased electricity outages since June 2022 hurt economic activity, the high rate of inflation, coupled with rising interest rates and weak consumer and business confidence, also inflicted significant pain.

The ongoing and substantial weakness in construction activity is especially troubling, since the South African government has been focused on encouraging infrastructural renewal in recent years.

Given the latest decline in GDP, the South African economy is forecast to grow by around only 1.8% in 2022. This forecast would be significantly higher if the country's productive sectors were embarking on a significant capex and employment growth initiative. Unfortunately, this growth rate is still below the rate required to inspire an increase in private sector fixed investment and widespread job creation.

SA's medium-term economic outlook has improved

While the next three to six months remain challenging for SA, it is not all bad news. There have been some positive developments that may see the economy improve going into 2024.

Firstly, in the short term, risks to inflation are still to the upside, given a range of factors including trends in global inflation, recent increased demands for higher wages, a weaker exchange rate, the potential of a prolonged spike in agricultural and food prices, and upward pressure on administered prices. However, inflation is expected to slow meaningfully in 2023, ending the year at around 4.6%, helped largely by base effects in fuel and food inflation.

Once inflationary pressures have abated more convincingly, the Reserve Bank will want to pause and assess the need for any further rate hikes – especially if the inflation rate is heading towards 4.5% at the end of 2023 and the major central banks are also considering ending their own rate hiking cycles. This should open the door for the Reserve Bank to consider cutting interest rates late in 2023 or early in 2024.

Secondly, there has been a systematic increase in private sector investment in the energy sector, especially following the announcement of the President's 'Energy Action Plan'. The acceleration of broader reforms to create a competitive electricity market, including the removal of the licensing threshold for embedded generation, has further stimulated private sector participation in energy generation. These reforms have unleashed over 80 private sector projects, some of which are expected to start in 2023 and gain momentum in 2024.

If implemented accurately, the energy plan should enable SA to achieve energy security. The 'Energy Action Plan' is critical to re-invigorating the economy over the coming years.

Given the early success in the energy sector, it is evident that government is moving ahead more purposefully with using public-private partnerships (PPPs) in other sectors.

This was shown in government's increased focus on reallocating expenditure towards infrastructure spending in the 2022 Medium-Term Budget Policy Statement (MTBPS). Government's current infrastructural development initiative, including allowing the private sector to get more fully involved, is likely to result in some announcements on ports, transport, and water projects in 2023 and work getting under way in 2024. Fixed investment growth is expected to jump to 4.8% in 2024, an 11-year high, amid increased activity.

Another positive development for SA is the continued improvement in the tourism industry. While the number of foreign tourists visiting SA on a monthly basis is still over 50% below pre-Covid levels, there has been an ongoing improvement. The average number of foreign tourists has increased from 188 000 per month in 2021 to almost 400 000 per month so far in 2022. As the summer season approaches, these numbers are expected to continue rising. This will generate additional income for the hospitality and services industry, and thus additional consumption spending.

Global inflationary pressures are expected to start abating in the latter part of 2023. This is likely to result in global interest rate cuts from the beginning of 2024 and improvements in the global economic outlook. According to the IMF, global inflation is forecast to decline to 6.5% in 2023 and 4.1% by 2024, while global GDP growth is expected to recover to 3.2% in 2024 from 2.7% in 2023. Overall, the global landscape should become more supportive for SA's economic outlook towards 2024.

Conclusion

Given all these developments, forecasts for SA's economic growth remain constructive. It is clear from the vast array of data provided by National Treasury in this year's MTBPS that current fiscal and economic reforms are only expected to begin yielding meaningful results over the next few years. Overall, the economic growth outlook for SA should start looking more positive in the second half of next year, going into 2024.

While 2022 and 2023 GDP growth will remain well below 2% amid ongoing load shedding, global headwinds and a lack of consumer and business confidence, 2024 is likely to be a better year. GDP growth is forecast to jump to 2.4% in 2024, which would be the highest growth rate since 2013, amid government's determination to push ahead with various critical fiscal reform measures. These measures are aimed at increasingly altering the mix of spending away from consumption and in favour of increased fixed investment activity, such as developing infrastructure.

STAND POINT

South African government bonds: cheap now on improving fundamentals

AT A GLANCE

SAGBs have not been spared in the global sell-off in government debt so far in 2022.

The outlook for SA's debt sustainability has significantly improved over the last year.

SAGB valuations are compelling against cash now and offer among the highest real yields in the world.

Victor Mphaphuli,
Head of Fixed Income

A 2022 bond market investor surveying the wreckage of their portfolio has a lot in common with Dorothy, the heroine of The Wizard of Oz. Like her, they have suffered a perfect storm and awoken to find themselves in a strange new country.

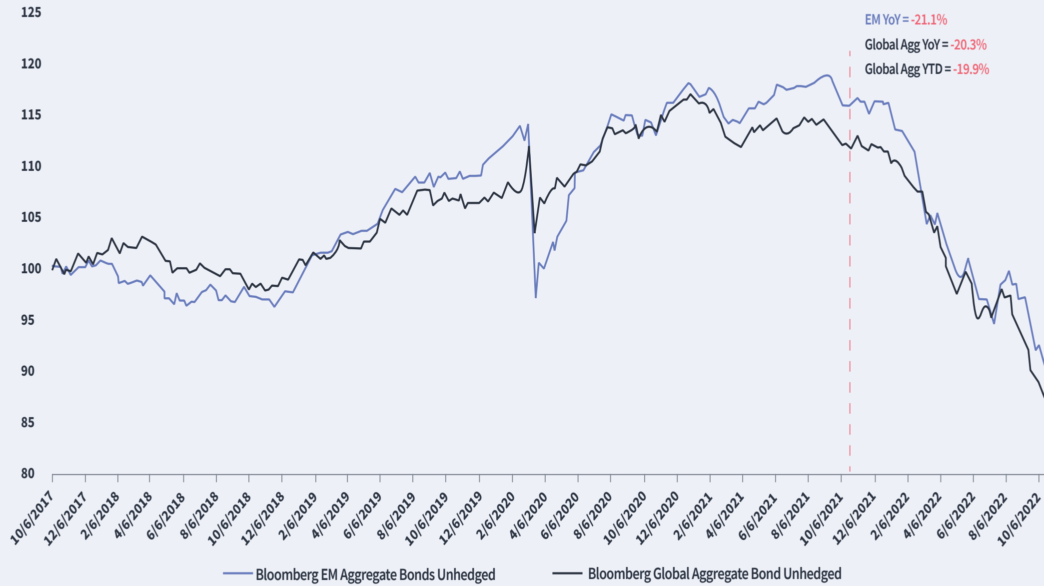
As Dorothy observes to her dog Toto, 'We aren't in Kansas any more'. In the end, Dorothy got home again simply by clicking the heels of her ruby slippers. By contrast, bond markets are stuck in a new and uncomfortable reality. That said, we think that South African government bonds offer good value after a big sell-off.

In 2022, the benign rate environment of the last fourteen years fell apart in spectacular fashion. Recession is looming and an entire generation of bond traders and investors are learning a new word: stagflation.

Sovereign bonds are in a generational bear market: global and emerging market indices are down 20% in USD terms year to date and you have lost money on the investment you made in sovereign bonds five years ago.

South African government bonds have not been spared. Like its peers, the South African Reserve Bank (SARB) was caught behind the curve and has been scrambling to reassert its credibility by hiking rates into positive real territory. Despite the current uncertainties and the country's weak growth outlook, we think that the fundamentals of South African sovereign debt are improving and it now offers value.

Figure 1. A Rare Bear Market in Global Bonds



Source: Bloomberg. Data as at 14 Oct 222

The story of 2022: inflation running hot, central bankers running to catch up

When inflation data started to break out earlier this year, central banks remained calm, characterising the increase in prices as transitory. Subsequent events have shredded that assessment: consumer prices have risen faster now than at any time in the last 40 years. Interest rates primarily affect demand in an economy, not supply, and are an inadequate weapon for central banks to suppress the current wave of inflation which is dominated by supply-side factors. Global supply chains were still reeling from the COVID-19 pandemic when Russia's invasion of Ukraine threw a hand grenade into the energy and food complex.

'Demand destruction' is the euphemism of the day. Rising rates mean that ordinary citizens must now foot the bill to get inflation under control. Fed Chair, Jerome Powell, admitted as much when he said in August that businesses and households will have to endure 'some pain' while the Fed tames the beast of inflation.

The SARB finds itself in an unenviable position, obliged to hike rates to defend a weak currency despite persistently low growth. The macro environment has certainly been challenging for the rand. The current account posted a surprise deficit in Q2 as the trade surplus narrowed by a quarter and the outflow of dividends and interest payments hit a 60-year record.

It may surprise you that STANLIB is bullish on SA sovereign bonds.

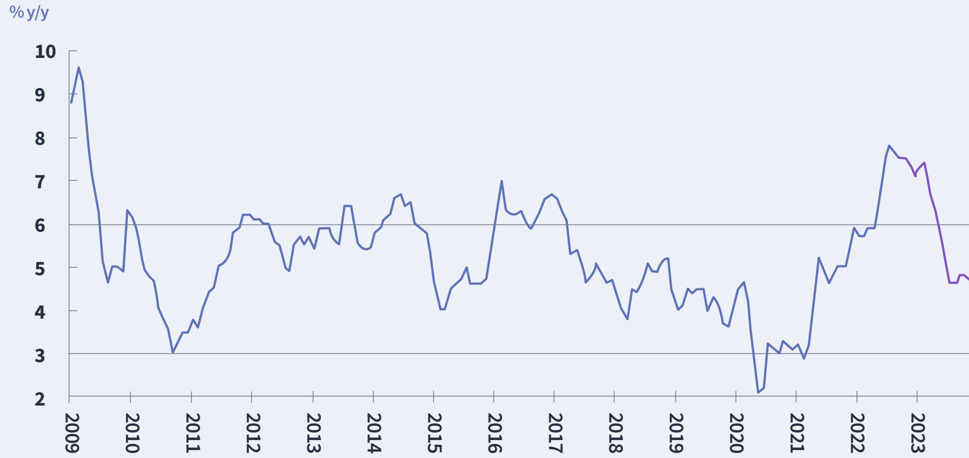
South Africans are notoriously bearish on the country's prospects (perhaps because load shedding tends to dampen one's enthusiasm), but our analysis indicates that the nation's finances and their governance are improving and that SA's sovereign credit rating will improve from here. If the government can deliver its promised reforms and fiscal consolidation, we believe that SA could return to the club of investment grade nations sooner than expected. It would certainly help if the politicians were to 'get out of the way' and prioritise the national interest over narrow factional interests.

Our bullish view on South African government debt is based on the following four observations:

1. Inflation has peaked

We think that consumer price inflation is peaking and that the SARB is now hiking to remain in step with central banks in developed economies to defend the rand. It would be naïve to expect the SARB to admit this in public forums, but defending the currency is rational. Weakness in the rand is a major driver of inflation and interest rate differentials are a key lever in the value of the currency.

Figure 2. South Africa Headline CPI Forecast



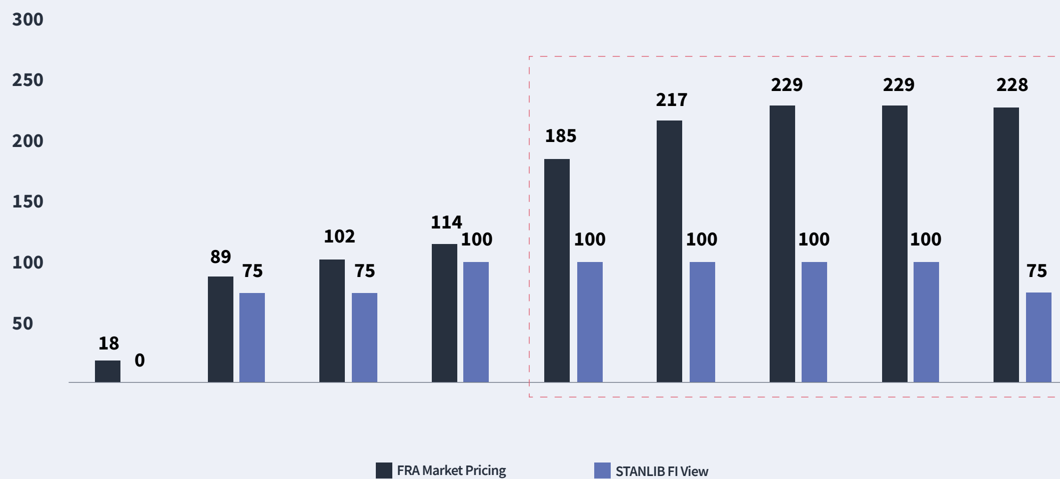
Source: STANLIB

2. Markets are too hawkish

Central banks in emerging markets have hiked their rates into 'neutral' territory (i.e. the real interest rate at which inflation would be stable at full employment) or beyond, and some have indicated a desire to decouple from their peers in developed markets (e.g. Brazil, Chile, Czechia, Poland). The risk that further currency depreciation will add to imported inflation is more of a risk for countries with poor external balances, like Hungary, than it is for SA. SA is also better-positioned by having less hard currency debt than its EM peers.

We therefore believe that fixed income markets are too hawkish on the path of South African interest rates: where they predict another 200 bps of tightening, we e expect no more than 100 bps.

Figure 3.

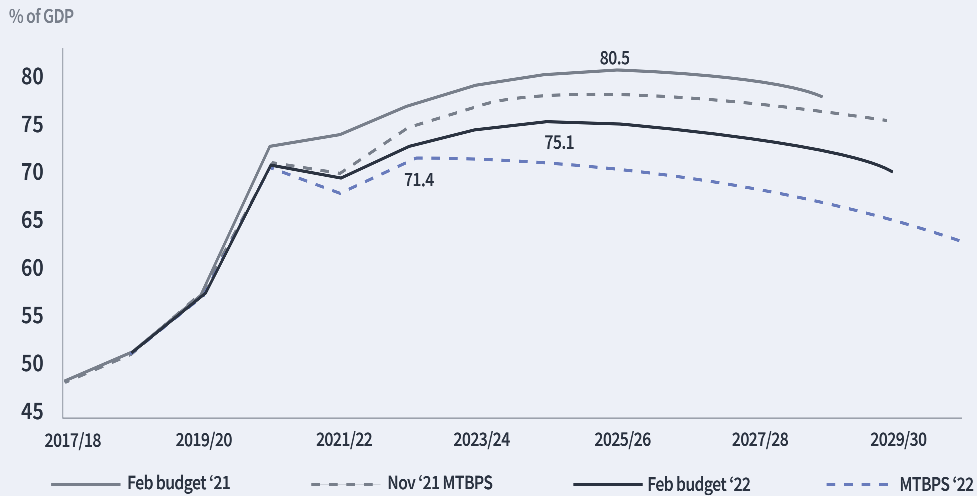


Source: STANLIB and Bloomberg

3. **SA's fiscal position is improving**

The South African government's finances are surprising on the upside. Fiscal consolidation is progressing faster than expected and we expect the primary balance (government revenue minus non-interest expenditure) will move into surplus sooner than expected, not least because of Treasury's increasingly effective gathering of taxes. The following chart shows how the recent Medium-Term Budget Policy Statement offered the third consecutive improvement in the government's debt trajectory since the February 2021 Budget.

Figure 4. MTBPS - A Much Better Promise Although Mired in Risk



Source: Vunani

4. **Valuations are compelling**

We believe that the market is overstating the risk of further hikes and there is good value in the short end and the belly of the SAGB yield curve. We expect more volatility over the short term but we feel we have a clearer view of value through the cycle based in the following:

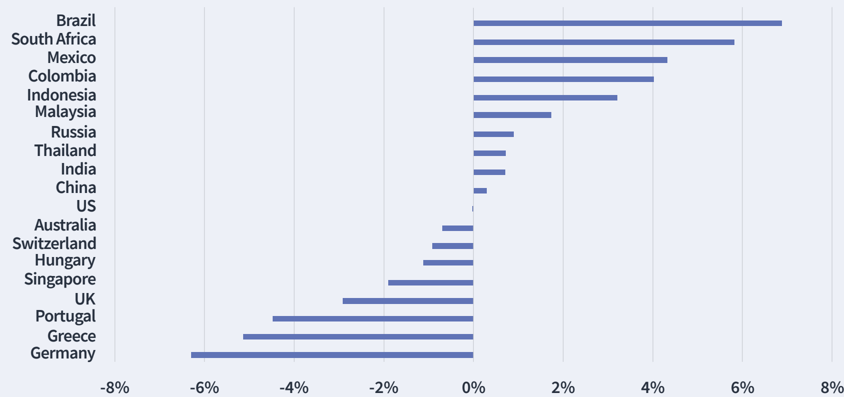
a. **Current valuations give room for error.**

The South African All Bond Index (ALBI) is now yielding 11.30% with a Modified Duration of 6.2 years. This means that the yield on the ALBI could rise by another 50 bps over the next 12 months and still deliver a return of 8.5%, equivalent to that offered by a 12-month cash deposit today.

b. **South African bonds are cheap relative to other countries**

South African government bonds (SAGBs) also look attractive on a real basis. Among major nations, only Brazil is offering a higher 10-year real yield (10-year government bond yield minus current inflation).

Figure 5. MTBPS - Major Nations' 10 Year Real Yields as of 2nd November 2022



Source: STANLIB

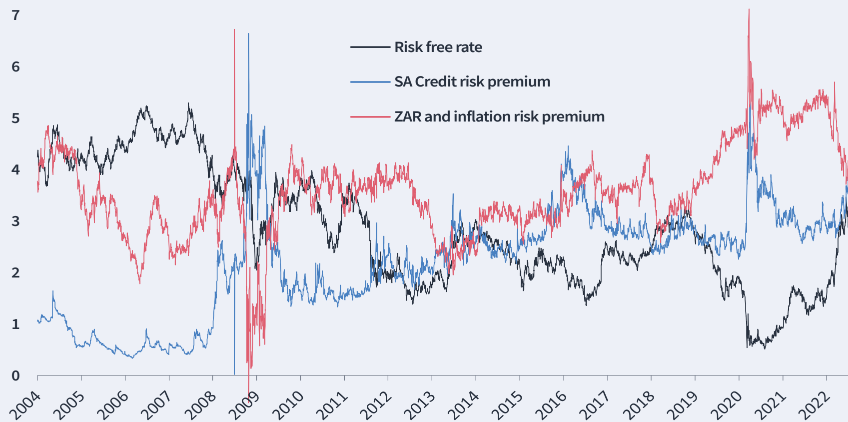
After years of underperformance, particularly during the COVID pandemic, SAGBs have been a big outperformer this year. Since the beginning of 2022, global and EM sovereign bonds have returned -19% and -21% respectively, while SAGBs have returned -0.3%.

c. The valuation of SAGBs reflects an excessively bearish view of sovereign credit risk

The following graph decomposes the yield on the benchmark 10-year SAGB into three notional 'building blocks'. Two of them are observable in markets and the third is the residual:

- the current yield on the world's reference 'risk free' asset (the US 10-year bond)
- the premium that investors are currently demanding for exposure to South African government credit (the current sovereign CDS spread), and
- the premium that investors appear to be demanding for exposure to the two remaining risk factors, the rand and South African inflation.

Figure 6. SAGB Valuation 'BuildingBlocks'



Source: STANLIB, Bloomberg

The chart shows that two of the three blocks have gone some way in the wrong direction for the value of South African bonds and should reverse over time. The US 10-year yield is at a cyclical high while the CDS spread is elevated and should retreat if our positive view of government finances plays out.

By definition, most successful investment strategies defy the consensus of the moment. Buying SAGBs might feel contrarian while load-shedding and grey-listing dominate the headlines, but we see compelling value in them now. Fundamentals are improving, foreign investors are underweight and South African bonds are conspicuously cheap against emerging market peers, who are facing their own challenges.

STAND POINT

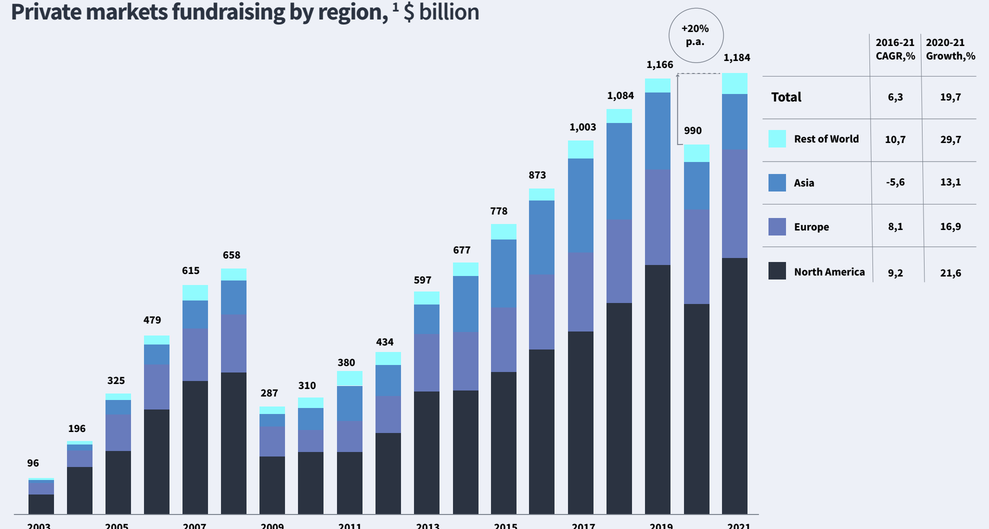
The role of private markets in the investment ecosystem

Johan Marnewick,
Head Credit Alternatives

What are private markets?

'Public markets' refer to assets listed and traded on a public exchange like the JSE. 'Private markets' describes the much larger universe of unlisted debt and equity assets and their investors. Examples of opportunities for private market investors include financial infrastructure such as microlenders, who make loans to the unbanked sector; social infrastructure such as schools; and physical infrastructure such as renewable energy generation, hospitals, and toll roads.

Private markets fundraising by region, [1] $ billion



	2016-21 CAGR,%	2020-21 Growth,%
Total	6,3	19,7
Rest of World	10,7	29,7
Asia	-5,6	13,1
Europe	8,1	16,9
North America	9,2	21,6

[1] *Excludes secondaries, funds of funds , and co-investment vehicles to avoid double counting of capital fundraised.*

Source: Preqin

Who participates in private markets?

To date, most individuals would have found it difficult to invest into unlisted assets directly. They have done so via their retirement funds, which are governed by the Pension Funds Act. Regulation 28 of the Act allows these funds to invest in unlisted assets, which gives their underlying investors exposure to types of assets and cashflows which they cannot achieve in public markets.

Private markets give institutional investors exposure to stable cashflows backed by real assets whose value does not rise and fall every day with the moods of the market. Private assets also tend to be less vulnerable to inflationary pressures than more traditional listed assets.

Private markets therefore have an important role to play in a diversified portfolio but are a demanding asset class. Investors should only access them using an accredited, institutional quality manager.

Recent changes to Regulation 28 have raised pension funds' maximum allocation to offshore assets and clarified their ability to invest in alternative investments such as private equity, debt, or hedge funds. Importantly, these changes mean that pension funds can now invest in a broad spectrum of infrastructure assets. This is a major step forward in the development of the infrastructure assets that SA desperately needs, especially in areas such as renewable energy, desalination, the digital economy, water, sanitation, and roads.

The South African government may be fiscally constrained but the country's retirement, pension and provident funds together manage more than R5 trillion of assets and are constantly seeking new investment opportunities. This deep pool of capital is not limited only to funding the next generation of SA's public infrastructure, but also applies the discipline, transparency, governance, and accountability that private sector investors demand and the public sector sometimes struggles to deliver.

Hand-in-hand: private equity & private debt

Broadly speaking, companies and projects raise two types of private market capital: debt and equity. Debt is a lower risk investment, since it is capital that must be repaid on a contractual basis. Equity is risky for investors but also essential to the raising of debt. Lenders require a layer of shareholder capital as their margin of safety. Private equity and private debt are both essential to the development of the capital-intensive infrastructure and private assets that SA needs. Of the two asset classes, debt represents a lower-risk entry point for investors who may be considering an exposure to unlisted assets for the first time.

Private markets solve problems for issuers

Stock market investors expect companies that are listing for the first time to be established businesses which are seeking capital for growth. Projects and businesses which are capital-intensive from the start require an investor mindset which is foreign to listed markets. If you wish to build a solar farm or a biomass power plant, you must raise all the capital you need before breaking ground. Lenders will not commit time to such a project until the equity is in place, while equity investors will not invest until they know that the debt has been arranged.

Private market managers are able to back long-term, capital-intensive projects because they have raised long-term capital - their underlying investors typically agree to lock up their capital for five years or more.

Private asset managers also have the expert resources to assess the prospects of the proposed business model and understand the legal, regulatory, political and market environments in which the enterprise will operate.

This is expensive and time-consuming work, but it can be lucrative because issuers know that private capital will be relatively expensive capital. To compensate for the risks of investing in an illiquid asset, private funds need to invest at valuations that ensure the return on a successful investment will be more than enough to give investors the returns they expect.

Private markets solve problems for investors

As mentioned, listed markets are not designed to finance capital-intensive enterprises, so they cannot give investors exposure to some

of the most interesting assets and the most valuable cashflows in the economy. By contrast, private markets have the vision and the mandate to 'fund the future'. This means that private markets offer investors exposure to entrepreneurial ventures that fall outside the remit of the listed markets: a power plant with a 20-year Power Purchase Agreement, a toll road with a 15-year concession, books of loans to farmers secured on their next harvest, or to African tertiary students to fund their college fees, or to South African pioneers of the sharing economy.

Private markets are perceived as 'riskier' than listed markets, but they offer access to more reliable, long-term cashflows and proportionately higher returns. Unlocking these unique opportunities requires fund managers with the specialist skills required to originate, manage, and then exit.

Private markets solve problems for society

Institutional shareholders' adoption of ESG may drive incremental change in the behaviour of big companies but listed markets themselves are not equipped to solve the existential challenges facing SA and the world. These challenges include the just transition to a lower carbon future, efficient transport infrastructure, financial inclusion, ubiquitous education, and modern sanitation for African megacities. It is the private markets that have the imagination, skills and capital required to fund the leaps required to solve for the future.

No easy wins: what it takes to succeed in private markets

To make consistent returns in private markets, managers need networks in the real economy and the skills to analyse the full range of legal, regulatory, operational, and technological risks facing a project. In addition, the illiquidity of private market assets makes ESG mission-critical for asset managers for whom all positions are long-term. Private managers must therefore set high ESG standards for portfolio companies and then monitor performance consistently.

Once an investment has been made, the manager must become a consistent partner in the business, monitoring performance, adding value to the board, and contributing to management's strategic thinking. Things do not always go to plan, of course. There will be failures in the portfolio and an effective manager must also possess the skills and strategies to recover as much value as possible.

Private markets offer attractive risk-adjusted returns but require a greater level of effort to make money than the stock market. Investors should only select an established and reputable institutional asset manager as their partner on the journey towards the exciting new frontiers offered by private markets.

STAND POINT

J.P. Morgan Asset Management's 2023 Long-Term Capital Market Assumptions

AT A GLANCE

Once again, 60/40 can form the bedrock of portfolios

Expectations are bonds will normalise and stocks soar

Scarce capital, surging demand for capex

Attractive market entry point for long-term investors

J.P. Morgan Asset Management's 27th annual edition of their Long-Term Capital Market Assumptions report explores how lower valuations and higher yields mean that markets today offer the best potential long-term returns since 2010. After a year of turmoil and the unwind of market dislocations, asset return forecasts move close to their long-term equilibrium – effectively "back to par."

Back to Basics

Lower valuations and higher yields mean that asset markets today offer the best long-term returns in more than a decade. It took a painful slump in stock and bond markets to get here, and the worst may not yet be over.

But after a year of turmoil, the core principles of investing still hold firm. Once again, 60/40 can form the bedrock of portfolios, while alternatives can offer alpha, inflation protection and diversification. Meanwhile, the end of free money, greater two-way risk in inflation and policy, and increased return dispersion across assets also give active managers more to swing for.

In the near term, investors face a challenging time as a recession, or at least several quarters of sub-trend growth, lie immediately ahead. Still, our assessment of long-term trend growth is only marginally below last year's. We expect today's inflationary surge to eventually subside to a rate only slightly above our previous estimates.

"After a year of turmoil, the core principles of investing still hold firm. Once again, 60/40 can form the bedrock of portfolios, while alternatives can offer alpha, inflation protection and diversification."

Bonds normalise, stock forecasts soar

Our forecast annual return for a USD 60/40 stock-bond portfolio over the next 10 – 15 years leaps from 4.30% last year, to 7.20%.

After policy rates normalised swiftly, bonds no longer look like serial losers. Once again, they offer a plausible source of income, as well as diversification. Higher riskless rates also translate to improved credit return forecasts.

Projected equity returns rise sharply. In local currency terms, our developed market equity forecast rises 340 basis points (bps), to 7.80%, and in emerging markets jumps 230 bps, to 8.90%. Corporate profit margins will likely recede from today's levels, but not revert completely to their long-term average.

Stock and bond valuations present an attractive entry point. Alternatives still offer benefits (diversification, risk reduction) not easily found elsewhere. With the U.S. dollar more overvalued than at any time since the 1980s, the FX translation will be a significant component of forecast returns.

Scarce capital, surging demand for capex

Many long-term themes affecting our outlook (demographics, shifts in globalisation patterns) will demand higher capital investment – paradoxically just as the abundance of cheap capital of the last decade is reversing. As financial markets look to efficiently allocate scarce capital, the result may be more idiosyncratic returns, and lower correlations within indices.

Overall, the return outlook in this year's Long-Term Capital Market Assumptions stands in stark contrast to last year's. Headwinds from low yields and high valuations have dissipated or even reversed, and asset return forecasts might be considered "back at par."

Asset reset, attractive entry point

It has taken a meaningful reset in asset markets to bring us to this place, and considerable pain for bondholders over a much shorter horizon than we had expected. Still, the underlying patterns of economic growth look stable, and the assumptions that underpin asset returns – cycle-neutral real cash rates, curve shape, default and recovery rates, and margin expectations – are little altered.

But the market drawdown in 2022 is now creating an increasingly attractive entry point for long-term investors. While 2022 was a painful ride as long-standing dislocations closed sharply, investors can now look forward to compounding future returns at much more attractive levels.

Read the full report and thematic insights here

The thematic reports included are:

- Globalisation will evolve – but not unravel
- Demographics and destiny: The challenges and opportunities of a 10-billion-person planet

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STAND POINT

Behavioural bias: investors ignore it at their peril

AT A GLANCE

The field of behavioural science teaches us that our decision-making is vulnerable to a range of unconscious biases

These biases pose specific threats to investors: our ancient brains are surprisingly poor at understanding data and prone to self-deception

Awareness of our cognitive frailties is an important factor in successful investing; staying true to long-term principles is another

Joseph Pearson
Head: Analytics, and

Anton Pietersen,
Senior Specialist:
Investment Analytics.

For the most successful species in the history of our planet, human beings are surprisingly poor at making sensible decisions based on our observations of the world around us. We 'moderns' may like to flatter ourselves that we are rational thinkers but in fact we are vulnerable to a range of unconscious biases that can lead us to irrational conclusions.

Daniel Kahneman: Explaining the pathology of irrational thinking

In his book 'Thinking, Fast and Slow', Nobel laureate Daniel Khaneman conceived a model of the human mind as an alliance of two 'systems'.

System 1: Fight or flight

System 1 is our 'ancient' brain which evolved to help Homo Sapiens survive and thrive in an environment full of danger. System 1 is fast and fully autonomous (you don't need to 'think' about whether the lion emerging from the tall grass is a problem) and is constantly maintaining a model of our surroundings. System 1 is capable of rapid, effortless assessments but is also highly vulnerable to cognitive bias.

System 2: The clever bit

System 2 is the 'modern' brain which allows us to grasp abstract concepts and wrestle with complex problems. System 2 is slow and demands conscious effort but is responsible for splitting the atom and putting a man on the moon.

System 1 made us a successful species; System 2 made us masters of our planet. In addition to being time consuming, lazy, and energy-intensive, System 2 has one structural weakness: before setting off on a problem-solving exercise, it will always ask System 1 for its 'opinion', thereby importing our ancient brain's unconscious biases. In this way our most 'rational' thinking can be subtly distorted in surprising and important ways.

Here are some examples of the unconscious biases that can influence the judgement of even the most 'rational' investor.

Hindsight bias

Humans are tempted to believe that we perfectly understand the past and can therefore predict the future. Google's success looks obvious in hindsight, but it has inevitably been the product of luck as well as judgement: the influence of fortune is a 'known unknown' which barely registers in the scale of our cognitive process beside the monolithic reality of Google today. We naturally conclude that it was always destined for greatness. As Warren Buffet points out, "In the business world, the rearview mirror is always clearer than the windshield."

Loss Aversion

Humans have an instinctive appreciation of risk and reward which may surprise you. Here are a couple of scenarios to consider:

Decision 1: choose between

A: a guaranteed profit of $250, or

B: a spin of a wheel which gives you a 25% chance of winning $1,000 and a 75% chance of winning nothing

Decision 2: choose between

C: a guaranteed loss of $750, or

D: a spin of a wheel which gives you a 75% chance of losing $1,000 but a 25% chance of losing nothing

In the language of probability, each pair of choices have the same expected value, but Kahneman's experiments reveal an interesting pattern: people will give up a chance of a big win to lock in a smaller profit (choice A), but will gamble to avoid locking in a loss (choice D). This is Loss Aversion: the reality that people are so innately reluctant to lock in a loss that they will risk an even bigger loss just to have a chance of escaping intact. To quote Kahneman, 'An investment said to have an 80% chance of success sounds far more attractive than one with a 20% chance of failure. The mind can't easily recognise that they are the same'.

This bias is conspicuous in the behaviour of gamblers who are having a bad day at the races: they will often bet more than their usual stake on the last race in order to recoup their losses. This is obviously irrational, but 'loss aversion' is whispering in their ear that they have a chance to 'make it all back'. It rarely ends well.

One can imagine how Loss Aversion can influence a portfolio manager's decision-making: as human beings they are innately reluctant to sell positions at a loss. One way to consciously override this bias is for the portfolio manager to see each stock within the context of the portfolio as a whole; they know that not every position will be a winner but can take comfort in diversification and portfolio construction to deliver good returns (assuming that their asset selections are right at least half the time). If they can consciously adopt this framework, they will find it easier to make rational decisions to cut their losers. As Nobel laureate Harry Markowitz said, 'diversification is the only free lunch in investing'.

The reality of running a portfolio cannot be entirely reduced to simple aphorisms like Peter Lynch's observation that selling your winners and holding your losers is like 'cutting the flowers and watering the weeds': sometimes losing stocks are just cheaper than ever, and sometimes winners are overvalued. Nevertheless, Loss Aversion is a powerful bias which against which we must be on our guard.

The Narrative Fallacy

As mentioned above, System 2 is clever but lazy. Storing information consumes intellectual energy so System 2 will look for ways to package data to save space. Narratives are an effective way to do this.

In 'Thinking, Fast and Slow' Kahneman gives a typically accessible example of this phenomenon. If, on the one hand, you were asked to memorise fifty random numbers, it would be a daunting task. If, on the other hand, you were told that the fifty numbers in question were the even numbers between zero and 100 it would take no effort at all since, they are described by a system, or narrative. The laziness of System 2 predisposes us to impose narratives on data, whether justified or not, and to be persuaded by them. In financial markets the Narrative Fallacy manifests itself in the temptation to extrapolate historic trends into the future and falsely impute a causal link between events. This is particularly dangerous for portfolio managers whose job it is to understand the range of future outcomes based on historic data.

Overconfidence

Asset management is a 'knowledge' industry: portfolio managers are paid to produce accurate assessments of economies, industries and companies and then express them effectively through the capital markets. Given the complexity of the task, successful individuals can be hailed as brilliant operators even though fortune always plays an unquantifiable role (as the market adage has it, 'Never confuse brains with a bull market'). Winning portfolio managers are always tempted to believe their own hype; as their belief in their own powers grows their healthy fear of the unknown must inevitably recede.

As Mark Twain put it, 'It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.' Overconfident managers build excessively concentrated portfolios as the benefits of diversification dim alongside their sense of their own talent. A strong risk management framework is the only remedy to overconfidence.

> **"The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome and the linkage between effect and cause is hidden from us."**
>
> *— Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk*

Confirmation bias

Overconfidence is compounded by humans' desire to justify their own beliefs, if only to avoid the intellectual effort involved in integrating new information and the psychological cost of adjusting one's view of the world. This is Confirmation Bias, the tendency to emphasise data points that confirms one's existing beliefs and to ignore those that contradict them. This is a deep bias that can contaminate a manager's entire investment process; it exacerbates Loss Aversion (see above) and undermines their ability to accept that events are not playing out in their favour. Confirmation Bias is anathema to John Maynard Keynes's famous aphorism: 'When the facts change, I change my mind. What do you do?

Investor know thyself

Kahneman's System 1 made Homo Sapiens an apex predator but does us no favours in financial markets. Our 'Fight or flight' instincts may have kept us alive for millennia but they inflict FOMO on investors as markets rise and naked panic when they fall: buying high and selling low is no way to make money. Awareness of unconscious bias is the beginning of wisdom for any investor; for those fortunate enough to be part of a team, a culture of honest debate is the best defence against the behavioural weaknesses which constantly undermine our 'rational' thinking.

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