PEREGRINATION

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PEREGRINE
WEALTH

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IT’S AN ELECTION QUARTER – MAKE YOUR MARK

George Herman
Chief Investment Officer

Geopolitical issues remain front and centre in the news as the situation in the Middle East escalates. Global shipping routes, affecting logistical supply chains and the supply and price of oil, have come back into focus for global trade just as disinflation has started to slow down. Suddenly inflation’s smooth path back to the United States (US) Federal Reserve’s (Fed’s) target has been interrupted, and bond yields have taken note, jumping higher as rate-cut expectations have been expunged for 2024. Add to that the frugal fiscal spending by the US government in an election year, and before you can say “Trump”, the market has already added an additional half a percent to long-term interest rate risk premia. Memories of the yield-led market sell-off of 2022 have come rushing back, but this time round technology stocks have the artificial intelligence (AI) theme to throw at any detractor.

The AI theme has been very strong since the third quarter of 2023 and has been responsible for a large proportion of stock market gains since then. The reality, however, is that yes, AI will change our lives, but it will take time for the monetisation benefit to filter through to new business models or for savings to stem from existing ones. You have to spend money to get the benefits, so the earnings uplift isn’t front-loaded. The market has started looking more rationally at tech and the benefits of AI and has taken a bit more of a cautious stance for now. This is very healthy for markets as overzealous risk appetite and market valuations get tempered.

The elections in India and the United States will be crucial for our investment universe. Both carry the potential for major policy changes that can have large impacts on certain asset classes and the respective currencies. Many scenarios are possible, with a wide variety of possible outcomes and impacts. At Peregrine Wealth, we maintain a cautious stance in all this uncertainty.

Enjoy this edition of Peregrination.

CANARY OR EAGLE?

Maarten Ackerman
Chief Economist

As we enter the second quarter of 2024, market participants are throwing in the looming recession towel. The United States (US) economy is still rallying, and the anticipated US recession is nowhere in sight. Over the last few quarters, we have been talking about the canary in the coal mine, where economic indicators have been pointing to a possible global recession. However, when it comes to the US, there is a sense that the canary may have escaped its cage and turned into the soaring American eagle.

The reason for this is that while most global economies are already feeling the recessionary pinch, the US economy remains surprisingly strong. So, the question on everyone's minds is - can this last? At Peregrine Wealth, we believe the US Eagle may well be about to catch a cold.

At the beginning of the year, consensus expectations were that central banks would start cutting rates as early as March, given the downward inflation trends. However, it didn't take long for that view to change. Due to the stickiness of US core inflation, coupled with the resilience of the underlying economy, any potential rate cuts continue to be pushed back for later this year.

When it comes to the global economy, the US stands alone. Currently, it appears that its economy is immune to the impact of higher interest rates. Whereas, in the other regions, China, the European Union (EU) and the United Kingdom (UK) we see a very different story. These regions are seeing extremely weak activity and are facing several headwinds for both the consumer and business. And when the US starts to see a slowdown, it will be even tougher for these regions. Indeed, this brings to mind the adage: "When America sneezes, the world catches a cold".

The US – don't be fooled by sentiment

While consumers may be feeling optimistic about the US economy at the moment, this is more a reflection of the current hype than what we believe is in the pipeline. Looking at current economic fundamentals, they certainly paint a less optimistic picture.

The better-than-expected economy is currently underpinning consumer sentiment. Consumer sentiment is what the consumer is feeling right now. It is being driven by the potential of interest rate cuts which will benefit consumers, as well as business and the economy. Consumer sentiment is also being buoyed by stronger-than-expected equity markets, which during the first quarter, reached new record highs – indicative of that soaring eagle. When we look at sentiment, we would be asking questions like: would you be prepared to buy a new fridge or TV right now? Strong sentiment sees people say yes, given the current buoyant environment.

Consumer confidence, however, looks to the future and asks whether people would be willing to make the same buying decisions six or 12 months down the line, for example, given the prospects for the economy and jobs. Consumer confidence is still very depressed and the gap between consumer sentiment and consumer confidence is widening. Low consumer confidence shows that the consumer is concerned about the future. So even though interest rates may decline, consumers are concerned that, in the future, there will be pressure on economic activity and job security.

US economic growth is still quite robust, and unemployment is low, but other employment trends are all pointing to a softer job market developing. Over the last six months, the low unemployment figures have been driven by part-time employment and by multiple job seekers – those people who are looking for a second or third job to make ends meet – while full-time employment has been flat. A recent survey indicated that 40% of American households rely on multiple jobs to make ends meet. This data shows that households are feeling the pressure. In addition, real-wage growth is also on a downward trend as inflation is getting softer. Last year, strong wage growth was helping consumers; this year, it has come to an end. Future hiring trends are down as companies are considering hiring fewer people going forward. In addition, job-quit rates are falling, which indicates that people are hanging onto their jobs because the job market is getting tighter. Currently, the US unemployment rate is at around 4%, which is still low compared to historical standards, but this can shift quickly if the economy moves into a slowdown phase. All of these trends point to US consumer confidence being tested.

Staying with the consumer, the higher interest rates are seeing US savings rates being depleted, meaning that any backup the consumer might have had to weather higher interest rates is disappearing. With this, we are seeing increased delinquencies on credit card debt, as well as vehicle loans and mortgages (to a lesser extent). The demand for consumer credit has increased by more than 5% over the last year, which is a clear sign that the consumer is not keeping up with the cost of living.

In summarising the US consumer's predicament – savings are being depleted, they are borrowing more, they are struggling to repay their debt and 40% of consumers need a second or third job just to keep the lights on. We therefore see that it is not a story of a soaring eagle, but rather one of a consumer being pushed into a very tight corner.

On the back of this, retail sales are down year-on-year, also pointing to a struggling consumer. Consumer spending contributes around 70% to overall US economic activity – given current developments we expect that consumer spending can turn into a headwind for overall economic activity over the next few quarters.

Turning to the business side of the economy the NY Empire State Manufacturing Index, which looks at US manufacturing activity, has dropped to levels that were only surpassed during the COVID-19 pandemic, indicating that manufacturing is under pressure and that new orders and shipments are down significantly. This is because global trade is soft, and the US cannot escape what is happening around the world.

Current indicators suggest that business investment plans are down, meaning that businesses are not planning to invest in new projects. This can be attributed to the fact that manufacturing activity is weak, which is further highlighted in the ISM Manufacturing Survey, which looks at the strength of the production side of the economy. A number above 50 suggests the economy is expanding and below 50 indicates the economy is in a state of contraction. The last print was only 50.3. When we look at the components of that index, we see employment is at 45 and declining. All of these trends are not painting a rosy picture for the US economy.

What's more, US trade, imports and exports are both negative compared to a year ago. This is not only a reflection of the state of the US economy, but the global economy as well. An interesting aside is that China has been supplanted as the US's top import source for the first time in 20 years, with Mexico taking its place. This speaks to the ongoing themes of supply-chain diversification, the US trade war with China, and bringing production closer to home.

Turning to US inflation, given the current sticky components, it seems like inflation is finding a floor around 3% which is still more than the 2.5% US Federal Reserve (Fed) inflation target. It is for this reason that the Fed keeps delaying its decision to cut interest rates. We do expect it to get there eventually as the US economy slows further. However, with tensions in the Middle East escalating, shipping costs coupled with higher oil prices mean that inflation might remain higher for longer – which implies that we can expect fewer, and less interest rate cuts this year.

Our view remains that the US economy will continue to slow further and will struggle to deliver growth in excess of capacity. US real growth should average around 1.8% per annum over the next three years.

The European Union – sitting with a bad case of flu

Across the Atlantic, the European Union (EU) is a bit of a mixed bag economically. The EU's growth engines, Germany, France and the Netherlands, are all in recessionary territories, while the peripheral regions like Spain and Italy are still experiencing positive GDP numbers.

Germany, a major global exporter, is struggling, which is always a reflection of what is happening in the rest of the world. German exports have fallen to their lowest levels since 2020, especially shipments to China and the US, which, from a year ago, are down 12% and 10% respectively. These numbers reflect the weak state of the global economy, with Germany being the quintessential canary in the coal mine. Locally, factory output in Germany has been falling for the last six months running. This has been its longest downward cycle since 2008, when the world experienced the Financial Crisis, and points to an extremely soft manufacturing environment, not only in Germany, but the entire EU, where manufacturing is down 6% compared to a year ago. In addition, the cost of doing business in Germany has increased, which is primarily energy related.

Beyond Germany, EU industrial production is also declining. While this has been the trend since 2022, the most recent data showed a fall of 6% year-on-year. On the back of this, the business climate index, which measures business sentiment, is also deteriorating, with no indication of it turning any time soon.

On the import and export side, new exports of goods and services continue to decline. Germany is down around 12% year-on-year, whereas the region has seen a drop of 3% year-on-year. On the import front, European imports have fallen 4.4% year-on-year, which indicates that Europe is struggling.

In looking at the EU consumer, we see that consumer confidence is starting to rebound on the hope of rate cuts. Yet, it remains below average levels seen over the past three years, meaning that it is not yet at a level that will support consumer spending. This is therefore having a direct impact on metrics like retail sales, which remain negative year-on-year, indicative of a struggling consumer. We are also seeing increased demand for credit and an increase in delinquencies on debt. Having said that, like in the US, the labour market is still robust and employment figures are strong. In fact, most EU countries are still experiencing historic-low unemployment numbers.

While EU inflation numbers are falling, they are not where the European Central Bank (ECB) wants them to be. In addition, unlike the US, EU inflation is coming off a weaker real economy, and it is more likely for the EU to have some downside surprises in its data related to the lag effects of higher interest rates. This makes the ECB's interest rate decisions trickier. However, due to the weakness of their economy, we might see the ECB start cutting rates sooner than the US.

Given these challenges we do expect the EU to grow below capacity over the next three years.

The United Kingdom – Going nowhere slowly

The United Kingdom (UK) is stuck in a state of stagnation. Last year, the country had to deal with the "flu" when it went into a technical recession. While it is seeing some improvement this year, this is coming off an extremely low base and it therefore will not experience any real growth. However, this slight recovery is improving household incomes somewhat and together with the potential for interest rate cuts, we should see an easing of credit conditions, which will further fuel consumption. Like the US, the UK's recovery is currently service-driven, with its construction and manufacturing sectors remaining weak.

The UK's long-term growth outlook, at 1%, is not cause for celebration. The economy is navigating the impact of the global geopolitical risks, as well as battling with the impact of Brexit as it no longer has all the trade benefits associated with belonging to the EU. This trade friction could hamper investment plans, which will pose additional headwinds for the economy. In addition, the UK is currently dealing with a unique issue. Its unemployment numbers are still good at around 4%, but youth unemployment is much higher at 12%. This will put additional social pressure on the national budget, which is already operating under tight conditions.

UK exports are down 9% compared to a year ago, reflecting slower demand around the world. Imports are down by 2%, meaning that net trade is negative, reflecting the UK's struggles. Like its peers, the UK is dealing with sticky inflation. But given the weak state of its economy, the Bank of England, like the ECB, may start to cut interest rates ahead of the US.

China – unwarranted optimism

Yolanda Naudé has written a comprehensive analysis of the Chinese economy in this edition of Peregrination. In brief, the Chinese government is hoping for economic growth of 5% and inflation of 3% for 2024. However, given the current state of the economy, which is experiencing a deflationary (falling prices) environment, a property sector in deep recession, a manufacturing sector which is sitting with severe overcapacity, high local-government debt levels and weak consumer confidence, we do not think that China is going to achieve these goals without targeted stimulus.

The headwinds the Chinese economy is facing reflect the soft global economic environment, a lack of demand due to weak consumer and business confidence, and local structural issues, which will not be easily remedied.

Outlook in summary

The rest of 2024 will be filled with much uncertainty and volatility. There will be a number of headwinds to contend with, before we start to see some light at the end of the tunnel. Geopolitical risks, contentious elections and the economic challenges discussed in this article are all going to impact markets this year.

Having said that, the turnaround in the global economic cycle is approaching. The question however, is how long will it take for the US economy to slow down, and what will the impact be on their trading partners across the globe? We believe a US slowdown remains in the pipeline. Only then will the outlook start getting better as these headwinds turn to tailwinds.

From an economic fundamental point of view, Peregrine Wealth remains cautious, and coupled with current market valuations all our solutions remain defensively positioned.

ASSET VALUATION SIGNALS

Harold Strydom

Investment Strategist

Scenario modelling has formed part of Peregrine Wealth's investment process for two decades, and it enables us to better understand potential market outcomes and construct stronger portfolios. The Peregrine Wealth Investment team has a core, or "High Conviction" scenario based on a three-year view, which is expressed as macro-economic and market assumptions, including economic growth, inflation, interest rates, price-earnings multiples, and credit spreads, to list a few. Based on these assumptions, our asset valuation models produce expected returns for various asset classes. This section is used to summarise our High Conviction view and the resulting asset signals.

Our High Conviction scenario assumes global economic growth close to capacity over the next three years. Economic indicators continue to paint a mixed picture, with traditional recession indicators flashing red, but there are signs of a cyclical recovery in leading indicators. While the effect of the sharp rise in interest rates is being felt across Europe, the United States (US) is more insulated, with consumers and businesses having fixed debt at lower rates. With inflation easing closer to the target, central banks are expected to start cutting rates, which is assumed to support economic growth. Monetary policy is assumed to remain more restrictive than the previous cycle, with higher real interest rates.

Earnings have tracked sideways for the last two years, but renewed earnings growth is projected over the next three years. Market valuation in the US is stretched, but Europe and emerging markets (EM) are trading close to fair value. Global equity has a neutral rating, along with Europe and EM, while US equity has a below-neutral rating.

Cash is attractive under our moderate rate-cut assumptions. Government bonds and investment-grade credit are rated neutral, with yields and spreads close to our fair value assumptions. High yield bond spreads are below fair value and less attractive.

The United Kingdom (UK) economy has exited its recession and growth is expected to get back to capacity. The Bank of England signalled that rate cuts will start middle of this year, which should help consumers and businesses recover. UK government and investment grade corporate bonds are rated neutral, with yields and spreads around fair value. The UK equity market has performed well, and while valuations are still reasonably attractive, weak earnings growth is projected. The expected return outlook is now neutral.

The table below offers a summary of our Medium-Term Asset Class Valuation Signals based on our three-year High Conviction scenario. It is important to note that valuation-based signals are typically not good short-term market timing tools.

Medium-Term Asset Class Valuation Signals

	Below Neutral	Neutral Outlook	Above Neutral	
Local (GBP) Assets				
UK Enhanced Cash	○	○	●	Rate cutting cycle to start this year
UK Goverment Bonds	○	●	○	Yields close to fair value; key diversifier in event of recession
UK Credit	○	●	○	Investment grade spreads close to fair value
UK Listed Property	●	○	○	Spread narrower than fair value; fundamentals under pressure in certain sectors
UK Equities	○	●	○	Valuations attractive, but weak earnings growth projected
Global Assets				
US Enhanced Cash	○	○	●	No further hikes assumed; first cuts expected later this year
US Goverment Bonds	○	●	○	Yields close to fair value; key diversifier in event of recession
US Credit	○	●	○	Investment grade spreads close to fair value
Gold	○	●	○	Sticky inflation, moderate equity expected return, and attractive gold fair value
Global Alternatives	○	●	○	Deliver longer-term attractive risk-adjusted returns
Global Property	●	○	○	Spread narrower than fair value; fundamentals under pressure in certain sectors
Global Equity	○	●	○	Valuations less attractive; decent earnings growth projected over three years
US Equity	●	○	○	Valuations not attractive; decent earnings growth projected over three years
EU Equity	○	●	○	Valuations close to fair value, but earnings growth outlook weaker
EM Equity	○	●	○	Valuations close to fair value; decent earnings growth projected over three years

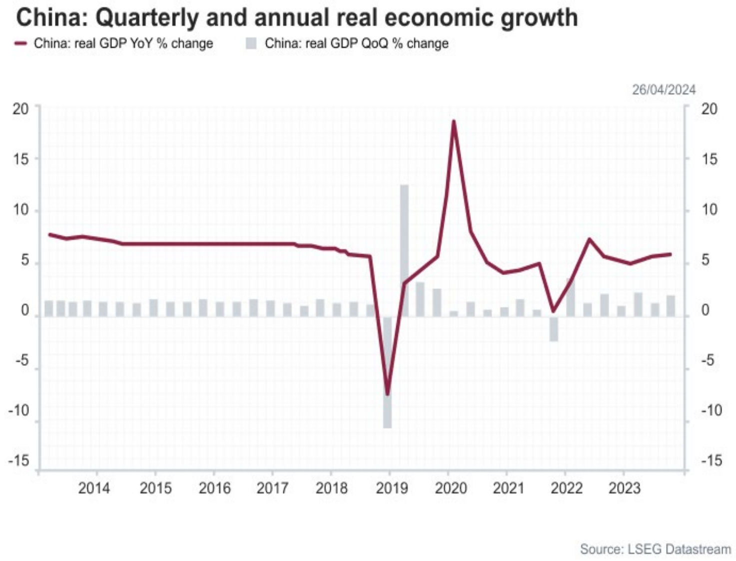
Outlook shown reflects the signals from Peregrine Wealth's asset valuation models and is based on each asset class's three year expected return. The model's expected returns are compared to what investors historically expected from these asset classes. As an example a Neutral Outlook will be roughly 0% real return for Cash, 2% for Bonds, 4% for Credit and Gold, and 6% for Equity and Property. Note that no currency views are taken and currencies are assumed to change in line with interest rate differentials for modelling purposes.

CHINA'S GROWTH AND INFLATION TARGETS SEEM OPTIMISTIC AND UNLIKELY, UNLESS…

YOLANDA NAUDÉ
Investment Strategist and Portfolio Manager

In the year of the dragon, which, in terms of the Chinese zodiac cycle, symbolises strength, good fortune and power, the 2024 economic growth and inflation targets announced by China's National People's Congress early in March this year seem ambitious and unrealistic. This is if Beijing does not announce further stimulus - targeted at the appropriate areas of the economy - soon.

On the back of last year's 5.2% real growth rate, which was bolstered by the low base of 2022, and an overall average annual consumer inflation rate of less than 0.5% in 2023, China announced a real economic growth target of around 5% and a headline consumer inflation target of around 3% for 2024. This is against a backdrop of an economy that was largely in deflation (falling prices) for the majority of last year and still is mired by a property sector that is in a deep recession, a manufacturing sector that sits with severe overcapacity, local governments that are hampered by high debt levels, and by a Chinese consumer that is reluctant to spend.



If one were to assess the outlook for the Chinese economy, one could break it down into its core components, using the following equation:

Chinese economic activity = household consumption expenditure + fixed asset investment spending + government spending + (exports – imports)

To expand on these variables:

Household consumption

In China, household consumption as a percentage of the size of the economy averages around 38% to 40%, compared with roughly 67% in the USA, for example. The outlook for Chinese household consumption spending in 2024 is going to be muted by unemployment rates, which although lower than during the peak of 2022, are still relatively high, and by depressed consumer confidence, due to the severe challenges in the property market and a flailing domestic stock market which has fallen precipitously over the past three years. We expect a modest recovery in household spending in 2024, which could be boosted if authorities were to implement specific support measures that target consumption. However, at this stage, this is absent and seems unlikely over the short to medium term.

Government spending

Government spending in China typically ranges between 15% and 20% of the size of the economy, which makes it one of the other core drivers of economic activity. Unique to China, the central government typically plays a limited spending role, while the action takes place at the local government level. And herein lies the rub: a big portion of the income from local governments comes from land sales. With the property market in deep distress, land-sale revenues have dried up, which is seriously hampering the abilities of local governments to spend, invest, and thereby boost economic activity. Beijing is attempting to prevent a spiralling local government debt crisis. Part of their current solution to this growing problem has been the issuance of special refinancing bonds through which local authorities can roll over the debt into lower-interest bonds which will then naturally reduce the interest payment burdens of local governments. Beijing has also approved some debt swaps and although positive, this seems insufficient to address this issue. In our view, local government finances are likely to be depressed for much of this year, hence placing the onus on the central government to boost spending and support economic activity.

At the central government level, debt is still largely contained, which does leave room for central government fiscal expansion. In December last year, China's central bank, the People's Bank of China, injected a significant amount of money via their so-called Pledged Supplementary Lending (PSL) programme for on-lending via state banks to further provide credit supply for their Three Major Projects programme to support urban village renovation, social housing and selected infrastructure projects that have a dual purpose, for example, buildings which could quickly be converted to hospitals, when/if needed. PSL funding operations were one of the core ways in which authorities helped stabilise the property sector during 2015 when they spent around CN¥3.5 trillion over four years, which equated to a roughly cumulative 5.5% of the size of the economy between 2015 and 2018. This is, therefore, an important source of potential further stimulus, which needs to be closely monitored for its likely progressively positive impact on economic growth going forward.

Fixed asset investment

From a fixed asset investment perspective, China stands out with a contribution of more than 40% to the size of the economy, versus around 15% to 17% in the USA. Of China's fixed asset investment, manufacturing fixed asset investment is by far the largest, followed by infrastructure investment and real estate. Manufacturing and infrastructure fixed-asset-investment spending have seen some explicit government support in recent years and are expected to continue to show decent growth going forward. However, it is the beleaguered property sector in China that remains one of its core Achilles heels.

Property Sector

If one includes the upstream and downstream industries related to the property sector in China, then the domestic property sector can easily constitute more than 20% of the total Chinese economy. Residential property ownership is abnormally high in China, and property constitutes roughly 60% of household wealth; hence, the health (or not) of the property market directly influences Chinese consumers' pockets, confidence, and spending.

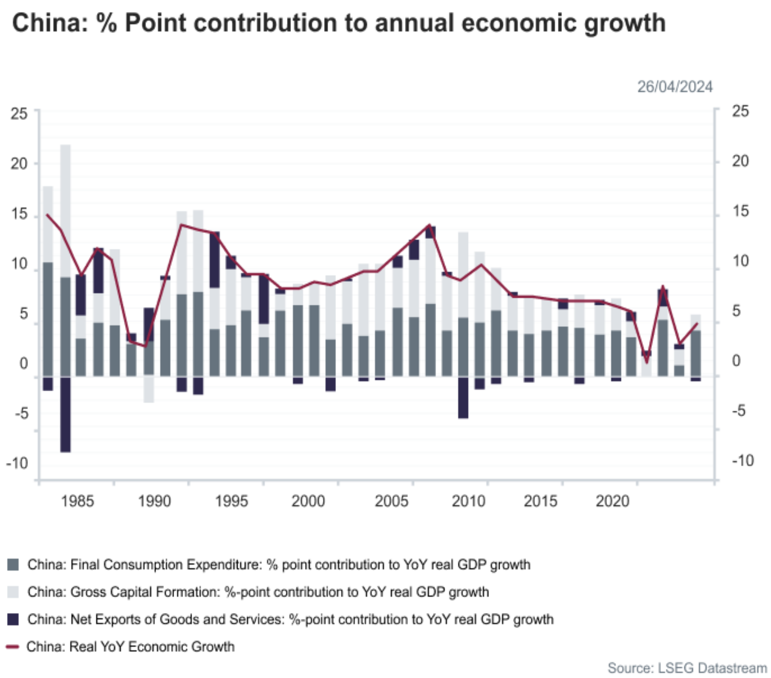
To a certain extent, China's current property woes are self-inflicted. Back in August 2020, Beijing introduced its Three Red Lines financial regulatory guidelines, which capped debt-to-cash, debt-to-assets and debt-to-equity ratios for Chinese property developer borrowing. This policy was implemented in order to address the sky-high debt levels of many companies in this sector. As a result, many developers became cash-strapped and were unable to finish property projects, which prompted mortgage boycotts by some buyers, defaults on property developer loans and even bankruptcy of some of the big players in this sector, including China Evergrande Group (which was one of the top three property developers by sales).

China's property sector is likely to take a very long time to heal as it not only grapples with confidence and developer funding issues in this current cycle but also must deal with the longer-term structural challenges regarding worsening demographics and slower urbanisation, amongst other factors. However, from a rate of change perspective, we are likely to see a smaller negative contribution from China's property sector to overall economic activity this year than in either 2022 or 2023 when floor space sold and started was deeply negative. Even if China's property sector were only to stabilise this year, and not grow, the impact on overall economic growth would be much improved versus the previous two years.

Exports less Imports = Net exports

Despite China having normalised from the peak of the work-from-home and personal-protection-goods demand cycle during the Covid years, and it having to deal with high-and-rising geo-political tension with the US in particular, China continues to be a major world manufacturer and global exporter, with a current market share of about 15% of global exports. On a stand-alone basis, Chinese exports easily constitute about 20% of the size of China's economy in any given year, while imports typically hover between 15% and 17% of the size of the economy.

What matters from an economic growth perspective is net exports (exports minus imports). In China's case, net exports are typically a small positive contributor to growth as China tends to run trade surpluses with the rest of the world (China exports more to other countries than it imports from them).



With an expected slowdown in global growth this year, and with fairly depressed Chinese local demand, we don't expect net exports to be a major contributor to growth this year.

Our China-2024 growth and investment outlook

Overall, and given the current stimulus in the economic system, we project 4.5% real economic growth for China in 2024, 4.25% in 2025, and 4% in 2026. These forecasts incorporate still significant economic challenges including weak consumption growth, unsustainably high debt levels and a property market which, at best, stabilises this year.

For China to reach its rather ambitious 5% growth target in 2024, it would need more than just good fortunes related to the Year of the Dragon. It would indeed need harmonised, flexible, and targeted additional fiscal and monetary stimulus and a more supportive regulatory environment to improve confidence, which encourages spending and investment. Without these, China's growth target will remain ambitious.

Overall, from an investment perspective, we acknowledge that the Chinese equity markets are undervalued following a period of severe underperformance, which subsequently pushed up its expected returns (see graph below). Often, from such deeply depressed valuation levels, technical rallies are possible off that low base. This is what we have witnessed in recent weeks when Chinese equity has bounced back from multi-year lows.

Article continues on the next page.

High conviction scenario: Risk-return plot

Source: LSEG Datastream

However, despite this recent rally, China still has a lot of lost ground to cover within the emerging market (EM) universe. Whether it achieves outperformance in the emerging market equity space going forward depends to a large extent on Beijing, which, at this stage, seems unwilling to embark on bazooka-like stimulus. As such, and for now, we maintain an on-benchmark exposure to China in our asset allocation.