intellidex
Researching Capital Markets and Financial Services

ETF Insights.
Prepared for clients of EasyEquities

The ETF Review

March 2023

Welcome to this month's ETF Review, a neat update of news affecting markets, as well as a set of favourite funds chosen by the Intellidex team. We collaborate with Intellidex to bring you the latest insights on ETFs – probably the niftiest way to invest!

Global equities pull back as global inflation reduction stalls

IN THIS ISSUE:

The momentum in global equities was stalled by a pause in US inflation, which led to investors revising their estimates of the terminal level of interest rates higher. Global economic activity showed signs of a recovery with a continued moderation in supply chain blockages and input costs. However, the services sector in major economies, which is recovering off a low base, risks contributing to lingering inflation due to rising wage growth.

Locally, SA was hit by another bout of crippling stage six electricity blackouts in February and was also grey listed by the Financial Action Task Force. Consumer inflation moderated but remains relatively high against an increasingly weak consumer backdrop. Businesses are also experiencing pressure given the effect of blackouts on operations and customers. As a result, we expect muted consumer and business confidence to continue, affecting economic activity and company earnings.

Overall, the ETF picks below reflect our continued preference for diversified ETF portfolios, especially given our earlier indications of the risk of persistent inflation and the resultant possibility of higher volatility in equities.

- CoreShares Sci-Beta Multi-Factor
- Satrix Rafi 40
- CoreShares World Stock Feeder
- Sygnia Itrix Euro Stoxx 50
- 1nvest Global REIT Index Feeder
- Satrix Divi Plus

Intellidex's favourite ETFs

Each month the investment gurus at Intellidex scan the market to come up with a list of their favourite ETFs.

Gershwyn Benjamin, explains:

We take a portfolio construction approach and classify all ETFs into six broad categories:

- Domestic equities
- International equities
- Bonds and cash
- Dividend or income-focused
- Multi-asset
- Commodities

Various empirical studies conclude that the bulk of equity returns stem from diversification among broad asset classes rather than from individual stock picking. As such, our grouping is done with a diversified portfolio in mind, ensuring appropriate exposure to different asset classes. First, we group the ETFs according to the three widely recognised asset classes – equities, bonds and cash. We further split equities into geographic groupings, then add a category for equity ETFs with an income theme.

Our picks should provide an investor with a relatively diversified portfolio made up only of ETFs. However, asset allocation is not a one-size-fits-all concept. You need to make sure that weights of different asset classes in your portfolio meet your unique risk-and-return objectives. Multi-asset ETFs, which are already diversified among asset classes, are analysed as a separate category.

As a rule of thumb, we like ETFs that follow a watertight investment philosophy. They should also be tax smart, which means they should qualify to be in a tax-free savings account. To avoid overconcentration, a good ETF should cap

What's happening in the markets?

Crippling stage six electricity blackouts and SA's grey listing by the Financial Action Task Force were some of the major developments in February. The budget speech (which was a slight positive) included a key announcement that the government would take on R254bn worth of Eskom's debt. However, this is subject to conditions which include Eskom not undertaking any capital expenditure in generation (only transmission and distribution).

Globally, US inflation printed at 6.4% annually in January (6.5% in December). However, it disappointed given market expectations of a 30 basis points decline to 6.2%. Consequently, markets increased their expected terminal policy interest rate (the rate at which the US Federal Reserve is anticipated to stop its current hiking cycle).

According to the Bureau for Economic Research (BER), markets expected the US Fed's rate to peak at 4.9% (currently at 4.5-4.75%) as early as the beginning of February. However, this "pause" in inflation led to markets shifting their expected terminal rate to approximately 5.3% instead, implying another 40 basis points worth of Fed hikes, with a single cut anticipated towards the end of the year.

From an equities perspective, the MSCI World Index declined 2.5% while the S&P 500 similarly dropped 2.6%. Equity markets fared better in the UK and Europe with the FTSE 100 gaining 1.3% and the German Dax increasing 1.6%. Locally, the JSE All Share index finished February 2.2% lower and the top 40 index similarly declined 2.4%. However, SA bonds inched 0.5% higher.

its exposure to a single sector and/or a single counter. While competition among providers is intensifying and ETF costs are coming down, we look at this metric closely and prefer ETFs with low total expense ratios (TERs). An overview of our favourite funds for each category follows.

The favourites:

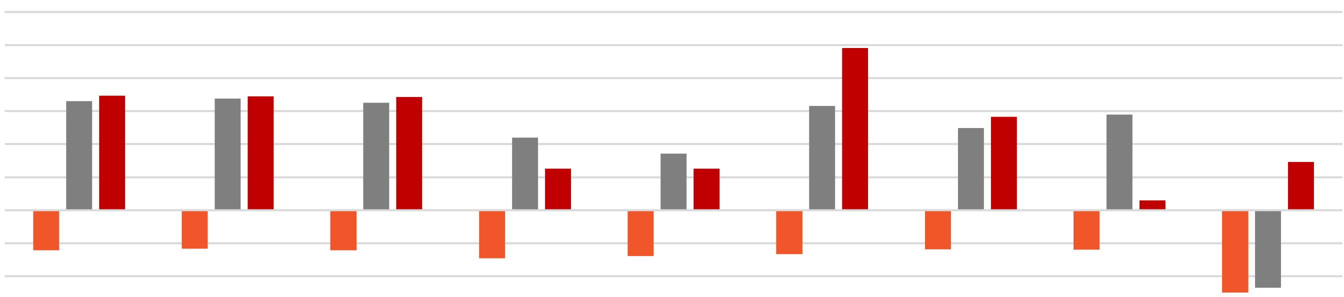
Domestic equity: CoreShares Sci-Beta Multi-Factor (SMART) and Satrix Rafi 40 ETFs (STXRAF)

This month's local picks emphasise our view that an allocation to SA equities must be diversified given the local economy's weak prospects. Accordingly, the **CoreShares Sci-Beta Multi-Factor ETF** (-2.4% in February) exposes investors to six investment styles (also known as factors). The styles - which have been proven to influence the returns of stock prices - include value, size (medium capitalisation), low volatility, momentum (high), high profitability and low investment (high cash flow) within the SA equities universe.

The value of diversifying across styles is that academic research finds that favouring a particular style (eg value, which favours shares that appear to be trading lower than their estimated intrinsic or book value but with relatively attractive prospects) leads to outperformance over the long-term but at the cost of short-term periods of high volatility.

This is problematic for low-risk equity investors that may sell their holdings, thereby guaranteeing losses. One drawback of the fund is that it costs

Domestic equity ETFs' performance (returns annualised for periods of more than one year - %)



	FNBT40J.J	STX40J.J	ETFT40J.J	STXSWXJ.J	ETFSWXJ.J	STXRAFJ.J	CTOP50J.J	SMARTJ.J	STXDIVJ.J
1-month	-2.4%	-2.3%	-2.4%	-2.9%	-2.8%	-2.7%	-2.4%	-2.4%	-5.0%
YTD	6.6%	6.8%	6.5%	4.4%	3.4%	6.3%	5.0%	5.8%	-4.7%
5-year	6.9%	6.9%	6.9%	2.5%	2.5%	9.8%	5.6%	0.6%	2.9%

Economic environment

Globally, US equities were lower after a strong start to the year in January as economic data indicated that consumer inflation is not slowing down as fast as investors would like. Specifically, January's inflation reading (which we discussed above) came in higher than expected. In addition, non-farm payrolls (employment figures) showed that the US economy created 517,000 jobs in January, which was far higher than the forecast of 185,000.

Also, data from the US Bureau of Economic Analysis shows that annual wage growth was 7.9% higher in January. We think this is positive for consumers, especially due to rising prices which should support disposable income. However, this continues to contribute to inflation remaining at elevated levels, particularly as the same reading was 7% annually in December.

The broader economy showed signs of stabilising - the S&P headline flash US Composite PMI rose to 50.2 points in February from 46.8 in January (value above 50 indicates an overall increase in economic activity and below reflects an overall decrease). The latest figure was the highest in eight months with the services sector showing a fractional uptick in business activity while manufacturers reported a slower decrease in output.

Inflation showed signs of abating in the EU, with annual price increases (consumer inflation) slowing to 8.5% in February from 8.6% in January. In particular, the warmer winter contributed to a slower rate in the increase (+13.7% yearly in February) of energy prices which rose by 18.9% in January.

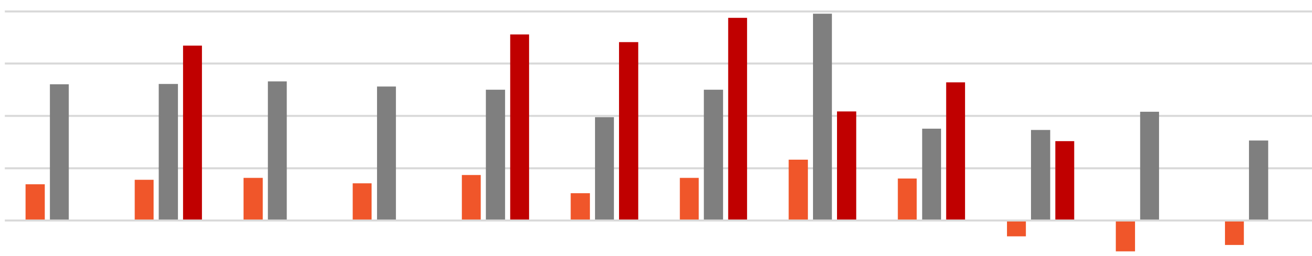
0.72%. However, we believe that part of the costs reflects the specialised nature of its index.

Our second pick is the **Satrix Rafi 40 ETF** (-2.7%) which ranks firms using sales, cash flow, dividends and book value, instead of market capitalisation. The ETF, which we covered in-depth in an ETF research note recently, exposes investors to the long-term fundamentals of companies, rather than market sentiment. Its index, which is also specialised, contributes to its 0.59% total investment cost.

However, our two ETF picks above are linked though fund exposure to basic materials, which averages 32%. With China's reopening well under way (the Caixin Manufacturing PMI increased to 51.6 in February – the first reading over 50 in seven months), local fund manager Anchor Capital expects China's commodity and consumer demand to be a key driver of the JSE's 2023 returns.

Both funds have healthy exposure to the consumer discretionary (think Richemont) and technology (think Naspers/Prosus) sectors. Also, JP Morgan expects the consumer sensitive sectors to recover followed by the longer-term themes such as the green economy and advanced manufacturing sectors which bodes well for the funds' basic materials exposure.

International equity ETFs' performance (returns annualised for periods of more than one year - %)



	GLOBALJ.J	STXWDMJ.J	ETFWLDJ.J	STXESGJ.J	CSP500J.J	SYG500J.J	STX500J.J	SYGEUJ.J	GLODIVJ.J	STXEMGJ.J	SYGEMFJ.J	STXEMEJ.J
1-month	3.5%	3.9%	4.1%	3.5%	4.3%	2.6%	4.1%	5.8%	4.0%	-1.5%	-2.9%	-2.3%
YTD	13.0%	13.1%	13.3%	12.8%	12.5%	9.9%	12.5%	19.8%	8.8%	8.7%	10.4%	7.6%
5-year	0.0%	16.7%	0.0%	0.0%	17.8%	17.1%	19.4%	10.4%	13.2%	7.6%	0.0%	0.0%

The estimate of EU GDP growth for Q4 2022 showed a mere 0.1% (quarterly) increase which was lower than the 0.3% expansion in Q3 but above forecasts for a slight contraction of 0.1%. It was the weakest pace of expansion since Q1 2021 as demand and activity were hit by high inflation and rising borrowing costs, as well as supply chain bottlenecks. Overall, the EU economy expanded by 1.9% annually in Q4 2022, compared to the 2.3% increase in Q3. Calendar year growth was 3.5% (2021:5.3%).

However, Eurozone business activity growth accelerated to a nine-month high in February, reflecting an improved performance of the services sector and a return to growth of manufacturing output, according to the S&P Global flash Eurozone composite PMI, which increased to 52.3 in February from 50.3 in January.

Rising demand, improvements in supply chains, order book backlog reduction and improved confidence underpinned the upturn. Importantly, S&P Global reports that the data is consistent with the economy expanding in the first quarter.

The UK recorded zero growth in Q4 2022 after falling 0.2% in Q3 2022, according to the Office for National Statistics. Monthly GDP data for December reflected a 0.5% contraction. This brings the British economy's calendar year (2022) growth to 4%, which was lower than the 7.6% growth generated in 2021.

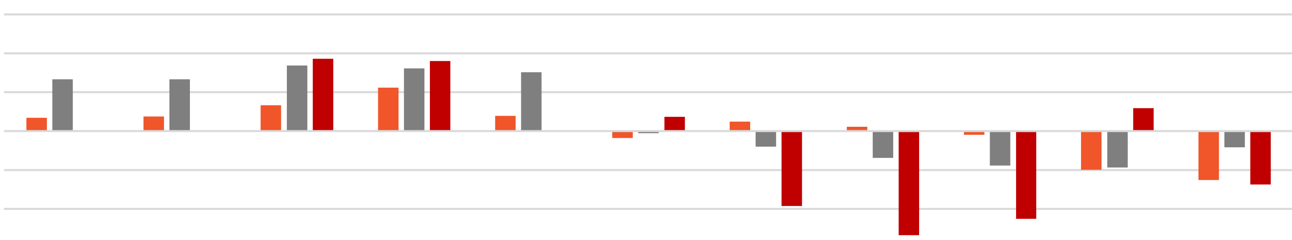
Foreign equity: CoreShares Total World Stock Feeder (GLOBAL) & Sygnia Itrix Euro Stoxx 50 ETFs (SYGEU)

Our first global equities pick is the **CoreShares Total World Stock Feeder ETF** (+3.5%), which we think of as a core holding for diversification purposes. The ETF provides exposure to global equities by tracking the performance of the FTSE Global All Cap Index. It tracks the index by investing in the Vanguard Total World Stock ETF, making it a feeder ETF.

It covers large, mid and small cap equities across developed and emerging markets, thereby maximising local ETF investors' exposure to global equities. As such, we believe this is good for diversification purposes. One of the fund's strongest points is its relatively low total expense ratio of 0.28%, which compares well to the Sygnia Itrix MSCI World Index (0.69%), 1nvest MSCI World Index Feeder (0.40%) and Satrix MSCI World Feeder (0.35%) ETFs.

Our satellite, or higher risk pick is the **Sygnia Itrix Euro Stoxx 50 ETF** (+5.8%). Higher energy prices owing to the Russia-Ukraine conflict have caused a surge in inflation in the EU. This led to central banks hiking interest rates to deal with the sharp price increases. Euro Area consumer inflation has since moderated to 8.5% annually in February (8.6% in January) from its peak of 10.6% in October last year.

Income theme ETFs' performance (returns annualised for periods of more than one year - %)



	FNBWGBJ.J	STXGBDJ.J	DCCUSDJ.J	DCCUS2J.J	ETFGGBJ.J	FNBINFJ.J	CSPROPJ.J	STXPROJ.J	ETFSAPJ.J	STXDIVJ.J	DIVTRXJ.J
1-month	1.7%	1.9%	3.3%	5.6%	2.0%	-0.9%	1.2%	0.5%	-0.5%	-5.0%	-6.3%
YTD	6.7%	6.7%	8.4%	8.1%	7.5%	-0.3%	-2.0%	-3.5%	-4.4%	-4.7%	-2.1%
5-year	0.0%	0.0%	9.3%	9.0%	0.0%	1.8%	-9.6%	-13.4%	-11.3%	2.9%	-6.9%

China's real GDP moderated to 2.9% annually in Q4 2022, easing from a 3.9% increase in Q3 as Covid-19 infections peaked in December following the Asian giant's late-November reopening. Tight lockdown restrictions (which were in effect for most of the quarter) and the peak in infections affected retail sales which declined 1.8% yearly in December. This was led by a 14.1% slump in food services sector sales. The economy is likely to perform better in Q1 2023 given the reopening in late-2022.

In the face of yet another hobbling bout of stage 6 blackouts in SA, the finance minister's budget speech included roof top solar incentives for firms and individuals. These were collectively R5bn and R4bn, respectively. Consequently, we expect an increase in rooftop solar uptake as businesses will be enabled to deduct the cost of their solar power system from their profits as a depreciation expense (up to 125%). The allocation of individual incentives for solar power, although welcome, will mainly benefit consumers who can afford to install solar-powered energy systems.

Outlook and portfolio strategy

The overall SA consumer base (which is made up of mostly low to-mid income earners) remains under pressure. Consumer inflation moderated to 6.9% annually in January. However, it was driven by higher food (+13.8%), fuel (+13.1%), electricity (+8.3%) and water (+5.5%) prices. Producer prices also remain elevated and were up 12.7% annually in January. This combined with the ongoing blackouts and SA's weak economic outlook should keep consumer and business confidence low.

Globally, composite PMI data shows that supply chain blockages and most input costs are starting to moderate, especially in major economic regions such as the US, EU and China. While this does not imply strong economic growth for 2023, it does indicate the increased likelihood of a quick and shallow economic downturn or avoidance of an economic downturn altogether.

Global fund manager Goldman Sachs expects the EU to avoid a deep recession, despite the negative effects of rising prices and higher interest rates on consumers and economic activity. It reports (2023 outlook) that the EU had cut Russian gas imports by 80% and total gas consumption by 20-25% towards the end of last year, supported by an unusually warm winter.

Goldman Sachs also reports that easing supply chain blockages has enabled EU giant Germany to replace energy-intensive industrial production with chip-intensive production. Finally, it expects pent-up demand and consumer credit capacity (which although lower than in the US) to support an economic recovery in the EU over the medium term. The Euro Stoxx 50 index traded at a forward price:earnings ratio of 12x and a forward dividend yield of 3.3% as at end-January. As such, we believe that this provides a reasonable margin of safety for higher-risk investors who may consider the Sygnia Itrix Euro Stoxx 50 as part of their overall ETF portfolio.

Bonds and cash: 1nvest Global REIT Index feeder ETF (ETFGRE)

Given the likelihood of moderate or persistent inflation and our preference for diversification, our income pick is the **1nvest Global REIT Index Feeder ETF** (+2.5%). An allocation to global listed property/Reits is useful as they provide inflation protection during high and moderate inflationary periods, according to data from the US-based National Association of Real Estate Investment Trusts (Nareit).

Investment returns from Reits also have a lower correlation with returns from the broader equities market. This increases the likelihood of one asset class outperforming when another underperforms, which is positive for investor portfolios. As such, data from the SA Reit Association indicate that the correlation between SA Reits and the Top 40 index was 0.4. Importantly, this was measured over a 10-year period (to end January 2023), which shows the potential benefits of low correlation over the long term.

However, using the example of the US, its economic stabilisation is being driven by the services sector, which took a hit during the pandemic and is recovering off a low base. As such, S&P Global has cautioned about the possibility of inflation moving from manufacturing supply chains into service-sector related wages.

In addition, we have highlighted the downside risk to investor expectations (in other ETF-specific research notes) of declining inflation and the beginning of interest rate cuts (especially in the US towards year-end). So with inflation showing signs of lingering, we stick to our view of well diversified ETF and equity portfolios. We also believe that a healthy allocation to offshore equities will be beneficial to local investor portfolios.

In particular, SA's economic woes and other global factors (including dollar strength on expectations of slightly higher interest rates in the US) have led to a 6.7% depreciation of the rand (at the time of writing) so far in 2023 – matching the exact loss in value of the currency for the whole of 2022. The weaker rand might not make investing cheaper offshore at present but the potential diversification benefits might be worthwhile for investors over the long-term.

Dividends: Satrix Divi Plus ETF (STXDIV)

The **Satrix SA Divi Plus ETF** (-5%) is our dividend pick for this month. The fund tracks the performance of the FTSE/JSE Dividend+ Index, which selects the top 30 stocks by a one-year forecasted dividend yield. The constituents' weightings within the index are determined by their dividend yield as opposed to market capitalisation.

This provides a forward-looking estimate of expected dividends, which is advantageous relative to peer indices that may use trailing dividend yield measures. However, the risk of forecasting error may be a disadvantage to investors when investing in the ETF. In addition, it is also relatively expensive with a total investment cost of 0.62%.

[Ends]