The ETF Review

February 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!

Broad-based energy price and interest rate increases around the globe

IN THIS ISSUE:

Markets began 2023 on a stronger footing, largely supported by China's re-opening and softer inflation from the US. The Federal Reserve hiked interest rates by 25 basis points in its first meeting for the year and stated that rate increases might be needed over the short term to bring down inflation.

Locally, loadshedding continued to dampen productivity and investor sentiment. SA faces a 45% probability of entering a recession this year mainly due to power outages, according to a survey of economists by Bloomberg. The SARB, which also increased the repo rate by 25 basis points in its first meeting of the year, expects economic growth of only 0.3% for 2023 with risks tilted to the downside.

The selection of ETFs is made with the market themes above in mind:

- Absa NewFunds Low Volatility Managed Defensive ETF
- Satrix FINI ETF
- Satrix MSCI China ETF
- Satrix MSCI Emerging Markets ETF
- Satrix ILBI ETT
- CoreShares S&P Dividend Aristocrats ETF

Intellidex's favourite ETFs

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

Sabelo Mnisi, 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?

Markets began 2023 on a stronger footing due to China's about-face on its zero-Covid policy and signs that its crackdown on tech companies is over.

China's re-opening, coupled with lower inflation figures from the US, led to widespread optimism and sent equity markets higher in January. The S&P 500 gained 6.6% while the tech heavy Nasdaq 100 expanded 13.2% - its best January performance since 2001's 12.2%. The Hang Seng was up 9.5% while the MSCI China Index rose 11.2%. The JSE ended January 8.8% higher. The dollar lost 1.7% on the back of cooler inflation and stronger gold prices.

The economic environment

China's scrapping of its zero-Covid policy and removal of quarantine requirements for tourists should encourage travellers to view the country as a tourist destination. The first day of the reopening saw as many as 45,000 people crossing the Hong Kong-mainland China border in either direction, according to the South China Morning Post.

The China Banking and Insurance Regulatory Commission stated that it will normalise regulations and encourage platform operators to display their capabilities of job creation and competitiveness. This lifted investor sentiment because Chinese regulators have been cracking down on tech companies in recent years. China's central bank announced that it plans to focus on boosting demand, particularly personal consumption, while strengthening supply-side structural reforms.

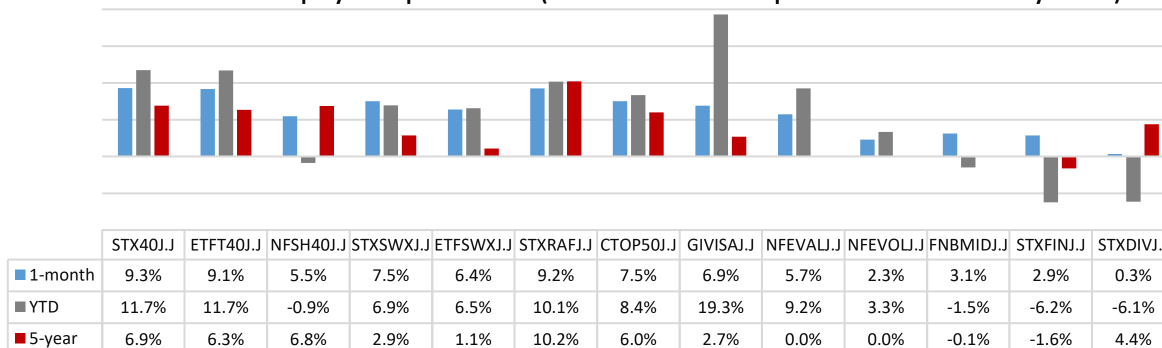
its exposure to a single sector and/or a single counter. While competition among providers is intensifying and ETF costs are coming down, we look at this metric closely and prefer ETFs with low total expense ratios (TERs). An overview of our favourite funds for each category follows.

The favourites:

Domestic equity: Absa NewFunds Low Volatility (NFEVOL) and Satrix FINI (STXFIN) ETFs

SA economic growth prospects look dim. As a result, our first pick on the local market is the Absa NewFunds Volatility Managed Defensive Equity ETF (5.7%). Generally, defensive companies tend to outperform regardless of the performance of the underlying economy. The fund invests in equities and cash in which the proportion depends on volatility levels in the market. During periods of high volatility, the fund allocates a sizeable portion to cash while during periods of low volatility it invests in equities. This fund invests in 30 highly liquid stocks that exhibit low volatility and low correlation with the overall market. It is relatively costly though, with a Total Expense Ratio (TER) of 0.48%. The ETF consists of defensive sectors such as the healthcare, consumer goods and telecoms. Some of the stocks within this ETF are attractive at current valuations. The fund has a fairly low net asset value of R55.2m.

While inflation is showing signs of abating, risks remain tilted to the upside. SARB governor Lesetja Kganyago recently stated that SA inflation expectations are more uncertain than ever, citing the weaker rand and surging oil prices. This suggests that monetary policy might be restrictive



	STX40J.J	ETFT40J.J	NFSH40J.J	STXSWXJ.J	ETFSWXJ.J	STXRAFJ.J	CTOP50J.J	GIVISAJ.J	NFEVALJ.J	NFEVOLJ.J	FNBMIDJ.J	STXFINJ.J	STXDIVJ.J
1-month	9.3%	9.1%	5.5%	7.5%	6.4%	9.2%	7.5%	6.9%	5.7%	2.3%	3.1%	2.9%	0.3%
YTD	11.7%	11.7%	-0.9%	6.9%	6.5%	10.1%	8.4%	19.3%	9.2%	3.3%	-1.5%	-6.2%	-6.1%
5-year	6.9%	6.3%	6.8%	2.9%	1.1%	10.2%	6.0%	2.7%	0.0%	0.0%	-0.1%	-1.6%	4.4%

In addition, the bank intends to widen channels for raising money for private firms, maintain credit growth and reduce finance costs. Furthermore, the government intends to bail out distressed major property developers affected by the crisis in the sector last year. A total collapse of the Chinese property market would undermine the economy and potentially global financial markets.

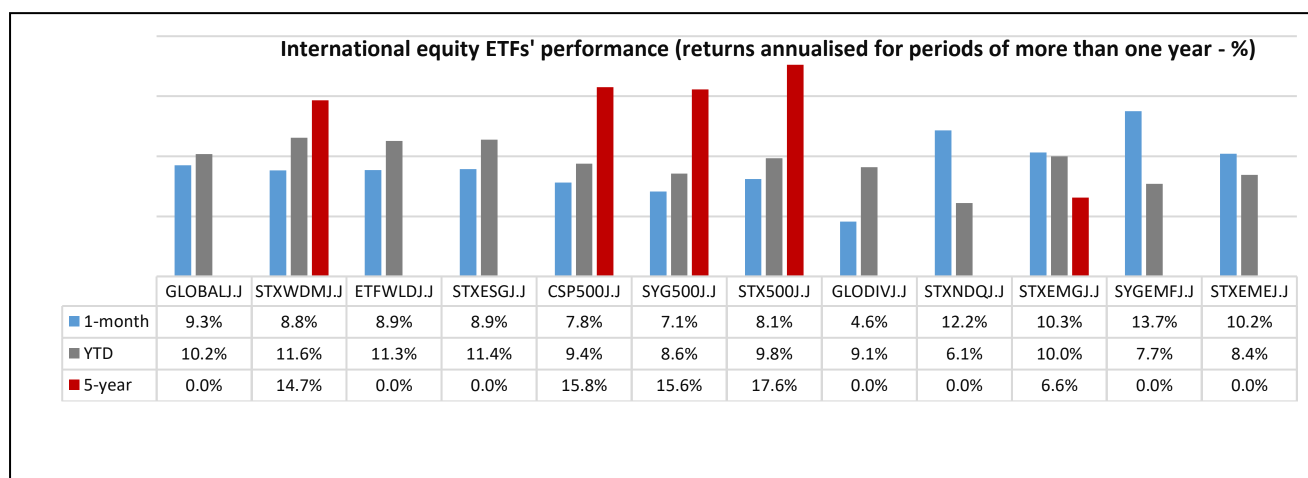
Inflation in the US continued along the path of its downward trend as it slowed to 6.5% year-on-year in December, which was the lowest since October 2021's 6.2%. Lower brent crude oil prices helped ease pressure on inflation. Core inflation, which excludes volatile items such as food and energy, slid to 5.7% year-on-year from 6% in November, suggesting that the slowing down of prices was broad-based. The Federal Reserve hiked interest rates by 25 basis points during its first meeting this year, which took the fed funds rate to 4.50%-4.75%, the highest rate since October 2007. The Fed stated that although inflation is slowing down, mild interest rate hikes may be required to contain surging prices.

Locally, annualised inflation eased to 7.2% in December 2022 year-on-year from 7.4% in November. The main contributors to the inflation figure were food and non-alcoholic beverages, transport and housing utilities which added 2.1, 2.0 and 1.0 percentage points respectively. Average annual inflation for 2022 was 6.9% from 4.5% in 2021. Several other categories recorded double-digit inflation growth such as fuel (22.8%), oils and fats (22.4%), breads and cereals (20.7%) and public transport (16.7%). Intellidex expects headline inflation to return to SARB's target range by end 2023. However, inflationary risks remain on the upside given the electricity tariff increase of 18.65% granted to Eskom effective from 1 April 2023.

until inflation comes back to the midpoint of the target range. As a result, we advocate for the Satrix FINI ETF (2.9%). The underlying index consists mainly of financial companies. Financials such as banks and insurers are well positioned to profit from a high interest rate environment because they generally have a sizeable amount of cash on their balance sheets or are able to lend to customers at higher interest rates. The fund comes at a TER of 0.43% and it is the only JSE-listed ETF which invests solely in financials. While sentiment is quite bearish on SA, our banking and insurance sectors rank as one of the best by global standards due their respective safety and soundness.

Foreign equity: Satrix MSCI China (STXCHN) and Satrix MSCI Emerging Markets (STXEMG) ETFs

We remain bullish on the **Satrix MSCI China ETF (14.0%)** as we did in the previous newsletter. China's reopening saw the country's major equity indices soaring higher. This ETF has a significant weighting to the information technology and consumer discretionary sectors, which tend to be sensitive to economic changes and have great upside potential. China continues to offer diversification benefits to a broader portfolio given its domestically focused policies, consumer size and manufacturing capacity. Major investment banks such as Goldman Sachs and Morgan Stanley have revised upward their views and expectations on



	GLOBALJ.J	STXWDMJ.J	ETFWLDJ.J	STXESGJ.J	CSP500J.J	SYG500J.J	STX500J.J	GLODIVJ.J	STXNDQJ.J	STXEMGJ.J	SYGEMFJ.J	STXEMEJ.J
1-month	9.3%	8.8%	8.9%	8.9%	7.8%	7.1%	8.1%	4.6%	12.2%	10.3%	13.7%	10.2%
YTD	10.2%	11.6%	11.3%	11.4%	9.4%	8.6%	9.8%	9.1%	6.1%	10.0%	7.7%	8.4%
5-year	0.0%	14.7%	0.0%	0.0%	15.8%	15.6%	17.6%	0.0%	0.0%	6.6%	0.0%	0.0%

Households and businesses which purchase electricity from municipalities will likely face a bigger increase as local governments tend to add their own markup and rates. This will have a negative effect on disposable incomes for households and on operating costs for companies.

Producer price inflation slowed to 13.5% in December year-on-year from 15.0% in November. Coke, petroleum, chemical, rubber and plastic products contributed 6.4 percentage points while food products, beverages and tobacco products added 2.6 percentage points. The PPI increase is much higher than the rise in CPI, implying that consumers are insulated against price increases.

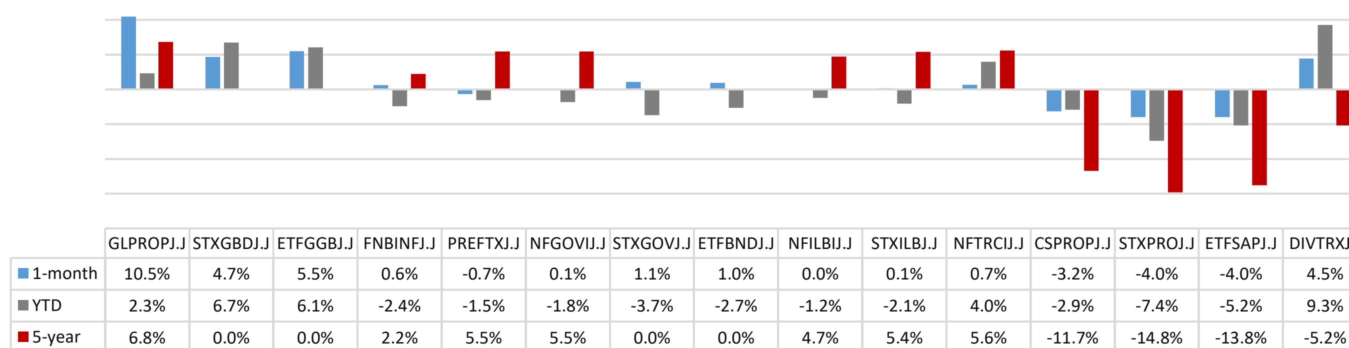
The elevated inflation figures prompted the SARB to raise the repo rate by 25 basis points to 7.25% (its eight consecutive interest rate increase) during the January monetary policy committee meeting, which took the prime lending rate to 10.75%. Although the rate increase was relatively mild, SARB governor Lesetja Kganyago is concerned about inflation remaining outside the target band for a prolonged period, implying that there may be a few more rate increases to come. He added that SA's prospects for growth are more uncertain than normal, mainly because of the ongoing power outages. The SARB now expects economic growth of only 0.3% for 2023 with risks tilted to the downside.

Retail sales for November increased 7.4% year-on-year. Historically, November and December have been stronger than the other 10 months. Last year's retail sales growth figures were likely curtailed by intense loadshedding. Indeed, electricity generation decreased 1.7% year-on-

Chinese equities, with an upgrade from Morgan Stanley to overweight while Goldman Sachs is forecasting double digit growth on the MSCI China Index.

The Lunar New Year break drew to a close towards the end of last month and markets were concerned about Covid infections spiralling out of control. This implies that the reopening might not be fully priced in as some uncertainty lingers. This is the only JSE-listed ETF which tracks the MSCI China Index. It has a portfolio size of R1.1bn and a steep TER of 0.63%. It is suitable for long-term investors who can stomach volatility.

Our second pick is the **Satrix MSCI Emerging Markets ETF (10.2%)** for investors who want to trim their exposure to Chinese equities. This ETF holds a diversified portfolio of stocks in different countries that have the potential to benefit from the Chinese reopening. China is a major trading partner to virtually all other emerging market economies and accounts for about one-third of market capitalisation in most emerging market indices, according to Morgan Stanley. As a result, investors place great emphasis on the country when allocating capital. In addition, the bank believes the market is underestimating the implications of the reopening. Morgan Stanley is bullish on China and remains optimistic about spillover effects to emerging market economies that are exporters of commodities. The reopening in manufacturing will amplify demand for oil as China relies heavily on the commodity for manufacturing. Manufacturing will also boost demand for precious metals such as gold and



	GLPROPJ.J	STXGBDJ.J	ETFGGBJ.J	FNBINFJ.J	PREFTXJ.J	NFGOVIJ.J	STXGOVJ.J	ETFBNDJ.J	NFILBIJ.J	STXILBJ.J	NFTRCIJ.J	CSPROPJ.J	STXPROJ.J	ETFSAPJ.J	DIVTRXJ
1-month	10.5%	4.7%	5.5%	0.6%	-0.7%	0.1%	1.1%	1.0%	0.0%	0.1%	0.7%	-3.2%	-4.0%	-4.0%	4.5%
YTD	2.3%	6.7%	6.1%	-2.4%	-1.5%	-1.8%	-3.7%	-2.7%	-1.2%	-2.1%	4.0%	-2.9%	-7.4%	-5.2%	9.3%
5-year	6.8%	0.0%	0.0%	2.2%	5.5%	5.5%	0.0%	0.0%	4.7%	5.4%	5.6%	-11.7%	-14.8%	-13.8%	-5.2%

year in November. Electricity distribution (consumption) declined 2.3% year-on-year in November.

Outlook and portfolio strategy

Global economic growth was resilient in the third quarter of 2022 with robust labour markets, business investment and household consumption, according to the IMF. Despite showing resilience and even with China's reopening, the institution expects the global economy to slow this year albeit by less compared to the forecast made in October when it expected a growth rate of about 2.7%. It expects global economic growth of 2.9% in 2023 with India and China accounting for about half of that growth. In addition, the institution expects emerging market economies to grow 4% this year and 4.2% in 2024. This suggests that investors should consider China and India when allocating their assets.

The IMF expects inflation to continue slowing down, however it believes that central banks should continue their goal of containing soaring prices. It anticipates global inflation to moderate to 6.6% in 2023 - still higher than pre-pandemic levels of about 3.5% - from 8.8% in 2022. This suggest that investors should not turn a blind eye to inflation just yet. It will be beneficial to add inflation-linked bonds to a portfolio for diversification benefits and to shield it against inflationary pressures.

Locally, we expect loadshedding to continue to dampen the economic growth potential and investor sentiment. SA faces a 45% probability of entering a recession this year mainly due to power outages, according to a survey of economists by Bloomberg. The Bureau of Economic Research believes that the power crisis is unlikely to fade in the short term, ranking Eskom as SA's biggest downside risk. Intellidex forecasts GDP growth of 1.7% in 2023 from an estimate of 2.4% in 2022.

Revenue and productivity of companies will be constrained as a result of the ongoing power cuts, while costs will be inflated, which will squeeze profit margins. This will lead to some inflation pass-through to consumers as companies try to recover costs through higher prices, thus putting upward pressure on inflation. Intellidex expects SA inflation to return to the target band by end 2023, with oil prices and loadshedding being one of the upside risks.

platinum, in which emerging markets play a crucial role.

Bonds and cash: Satrix ILBI (STXILB)

Although inflation appears to be cooling down, its risks remain to the upside as a result of global supply chain disruptions, among other things. SA inflation is vulnerable to external shocks that feed through its volatile exchange rate. As a result, our bond pick is the **Satrix ILBI ETF (0.1%)**. We continue to favour SA bonds as they pay a premium for being rated as sub-investment grade. It is necessary for investors to pay attention to the growth of their investments along with the inflation rate. The Chinese reopening will amplify global demand for oil and send brent crude prices higher, which will result in elevated prices. Indeed, Morgan Stanley forecasts Brent crude oil to rise to $107/bbl from the current level of $85/bbl by 2023-end.

Inflation-linked bonds are designed to help protect investors from inflation. These bonds are indexed to inflation so that the principal and interest payments fluctuate with the rate of inflation. They offer additional benefits in a broader portfolio context.

Dividends: CoreShares S&P Global Dividend Aristocrats ETF (GLODIV)

In an uncertain earnings environment, we advocate for the **CoreShares S&P Global Dividend Aristocrats ETF (7.8%).** The fund has risen 15.8% over the last five years. It is suitable for investors who rely on regular income from investments. The underlying index has significant weighting to consumer staples, financials and energy. This ETF invests in high dividend-paying companies. It has a TER of 0.57%.

Dividend stocks yield capital returns in addition to regular income, which makes them less volatile than the overall market. Because of their lower volatility, dividend stocks often appeal to investors looking for lower-risk investments, especially those in or nearing retirement.

Broadly, we advocate for defensive companies with strong fundamentals such as resilient cash-generation supported by solid balance sheets and with sustainable dividend policies. We also advocate for financial services such as banks and insurance companies as they are well positioned to benefit from the sharp interest rate increases. Profit margins for banks tend to widen as they charge higher interest rates on loans. We also favour SA bonds because they yield premium returns for being rated as sub-investment grade.

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