intellidex
Researching Capital Markets and Financial Services

ETF Insights.
Prepared for clients of
EasyEquities

The ETF Review

December 2022

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!

Equities resilient on the back of dovish central bank sentiment

IN THIS ISSUE:

Global equities rallied in November as inflation in major economies such as the US and EU showed signs of slowing down. Importantly, this led to dovish sentiment by the US Federal Reserve, which signalled the possibility of less aggressive monetary tightening in the future. In China, the announcement of reduced lockdown restrictions buoyed equities and may lead to a recovery in slowing economic activity.

Locally, equities also benefitted from this positive sentiment. However, domestic factors continue to pose a risk to the real economy (activity, investment and job creation) and stalled the upward momentum of financial markets. Moving forward, we believe lower inflation and an uptick in global economic activity off a low base will provide further support to global equities, especially emerging market and value shares that are attractively priced. This provides a margin of safety to investors given the risk of higher inflation or recession for a prolonged period.

The selection of ETFs is made with these respective market themes and diversification in mind:

- CoreShares Top 50
- CoreShares Total World Stock Feeder
- Sygnia Itrix MSCI Emerging Markets 50
- Satrix SA Bond
- CoreShares S&P SA Dividend Aristocrats

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?

Global equities rallied during November as the pace of price increases in major economies such as the US and EU showed signs of slowing down. Importantly, this led to dovish sentiment by the US Federal Reserve, which signalled the possibility of less aggressive monetary tightening in the future.

Locally, equities also benefited from this positive sentiment. However, as is usually the case, domestic factors continue to pose a risk to the real economy (activity, investment and job creation) and stalled the upward momentum of SA's financial markets. Overall though, November was a strong month as global investor sentiment started to improve on hopes that inflation may peak soon and that global economic activity is declining at a slower rate.

The MSCI World, a barometer of global equities, added 6.8% during November. Its tech-heavy counterpart, the S&P 500, was up 5.4%. Sentiment in other developed markets also improved, with the German Dax, French Cac 40 and the UK's FTSE 100 increasing by an average of 7.6%.

The economic environment

The local economy ended the month on a sour note with the finding by an independent panel that President Cyril Ramaphosa may have a case to answer on various broken laws in relation to both business activity and the subsequent failure to report the theft of foreign currency at his private farm. While most financial market participants may enjoy the prospect of markets being driven by fundamentals and less by politics, SA is a typical example (given the case above) of that not being the case.

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:

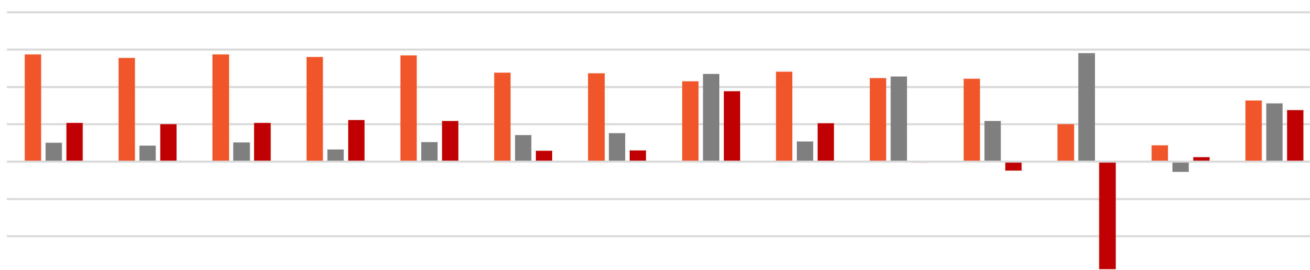
Domestic equity: CoreShares Top 50 (CTOP50)

As is the case in major global economies, the decline in SA output seems to have slowed. The S&P Global SA PMI improved to 50.6 points in November from 49.5 in October. The increasing new business volumes supported employment numbers at firms, boosting the PMI. However, businesses continued to grapple with the hobbling effects of electricity blackouts which led to a decline in output levels and an increase in backlogged work.

From an equities perspective we start with rand hedges, with the most prominent being Naspers and Prosus. The pair returned a sizeable 38.7% and 40.5% off a very low base in November. Local fund manager Anchor Capital expects China-based gaming giant Tencent's performance to be further driven by internal factors such as asset sales, restructuring and prudent capital management.

Tencent, which is 28% owned by Naspers through a 43% holding in Prosus, is the group's main asset held alongside other high growth tech-education and e-commerce businesses. As such, Anchor's strategic expectations imply that revenue growth does not need to be significantly high to drive

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



	FNBT40	STX40	ETFT40	SYGT40	NFSH40	STXSWX	ETFSWX	STXRAF	CTOP50	GIVISA	SMART	NFEVAL	FNBMID	STXDIV
1-month	14.4%	13.9%	14.4%	14.0%	14.2%	11.9%	11.8%	10.8%	12.0%	11.2%	11.1%	5.0%	2.2%	8.2%
YTD	2.5%	2.1%	2.6%	1.6%	2.6%	3.5%	3.8%	11.7%	2.7%	11.4%	5.4%	14.5%	-1.4%	7.8%
5-year	5.2%	5.0%	5.2%	5.6%	5.5%	1.5%	1.5%	9.4%	5.2%	-0.1%	-1.2%	-14.4%	0.6%	6.9%

The rand slid 3.3% (29 Nov - 2 Dec) against the dollar. In the bond market, SA's 10-year yield peaked at 10.97% before ending at 10.74% over the same period. Yields and bond prices have an inverse relationship, which means that prices drop when yields increase. In addition, the share prices of SA's big five commercial banks – which are most exposed to the local economy – lost an average of 5.7%.

SA's unemployment rate declined to 32.9% in Q3 2022 from 33.9% in Q2, according to Stats SA's Quarterly Labour Force Survey. However, the Bureau of Economic Research states that the recent bump in employment figures – which shows that employment increased by 204,000 in Q3 and 648,000 in Q2 – is overstated due to the resumption of face-to-face interviewing as part of the survey methodology.

We end on a somewhat positive note: SA's Q3 real GDP surprised on the upside, growing 1.6%, according to Stats SA. This translated to a 4.1% annual increase in local output. The quarterly increase was driven by a strong performance in the agriculture, forestry and fishing industry which recorded a 19.2% rise in output. This led to the sector contributing 0.5% of the 1.6% quarterly growth.

Globally, markets were buoyed by dovish sentiment coming from the US Federal Reserve. Specifically, the latest minutes of the Fed's November Federal Open Market Committee (FOMC) meeting indicated that Fed officials recognise that interest rates are now approaching a sufficiently restrictive position. The minutes also report that most Fed officials expect the pace of rate hikes to slow down in the future.

earnings and cash flow at Tencent. Also, given that Naspers is expected to slowly sell down a portion of its stake in Tencent to drive shareholder returns, Anchor is positive on the investment case of both companies.

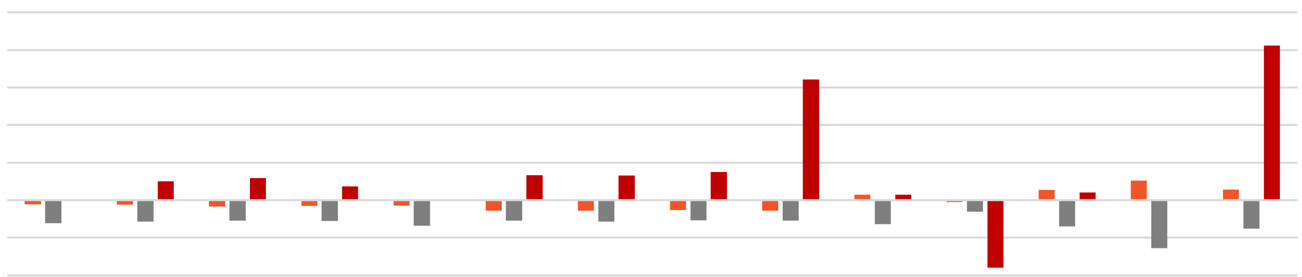
Anchor is also relatively positive on "SA Inc" with forward multiples being quite low and earnings expectations being moderate against a weak economic backdrop. Importantly, we believe that the low multiples provide a margin of safety when investing in SA. As a result, we think broad exposure through the **CoreShares Top 50 ETF** (+12% in November) would be a good core equity ETF holding.

Foreign equity: CoreShares Total World Stock Feeder (GLOBAL) & Sygnia Itrix MSCI Emerging Markets 50 ETFs (SYGEMF)

Given JP Morgan's expectations of moderate inflation and a mild recession in 2023, we believe that broad global equity exposure is the best way to implement a diversified ETF portfolio. Accordingly, our core pick for global equities is the **CoreShares Total World Stock Feeder ETF** (-2.2%), which consists of over 9,000 shares across both developed and emerging markets.

Emerging markets have come under significant pressure over the last 18 months. The MSCI Emerging Markets index was down 16% year-to-date by end-November. However,

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



	GLOBAL	SYGWD	STXWDM	ETFWLD	STXESG	CSP500	SYG500	STX500	ETF500	SYGJP	GLODIV	STXEMG	SYGEMF	STXEME
1-month	-2.2%	-2.4%	-3.5%	-3.1%	-2.9%	-5.6%	-5.6%	-5.4%	-5.6%	2.8%	-1.1%	5.5%	10.3%	5.6%
YTD	-12.3%	-11.3%	-10.9%	-11.0%	-13.6%	-11.0%	-11.4%	-10.7%	-10.9%	-12.8%	-6.2%	-13.9%	-25.5%	-15.2%
5-year	0.0%	10.0%	11.7%	7.4%	0.0%	13.3%	13.0%	15.0%	64.3%	2.8%	-36.0%	4.1%	0.0%	82.3%

Given that annual US consumer inflation dropped to 7.7% in October – which exceeded consensus (on the upside) forecasts of an 8% reading – markets are expecting less steep rate hikes in the future. Accordingly, the first of these is a 50 basis points increase in December, which would deviate from the trend of 75 basis points hikes in the previous four meetings.

Conditions in the **EU** appear comparatively worse but economic activity may also be showing signs of stabilising. Consumer inflation eased to 10% annually in November from a record high of 10.6% in October. The November reading exceeded (on the upside) the consensus forecast of 10.4%.

The eurozone composite purchasing manager's index (PMI - reflects overall direction of the economy; value of 50 is neutral) indicates that economic activity may be recovering off a low base. The index value recovered to 47.8 in November from 47.3 in October, marking a slower rate of decline in economic activity.

S&P Global, which publishes the index, reports that there was a softer decline in demand for goods and services and manufacturing activity. On the upside, employment continued to increase, albeit at the weakest rate in two years. Encouragingly, backlogs of work and input cost inflation declined, showing signs of an ease in supply chain pressures.

In the **UK**, consumer inflation showed no signs of retreating as it soared to 11.1% annually in October from 10.1% in September. As in the EU, energy costs were the main driver of prices increases.

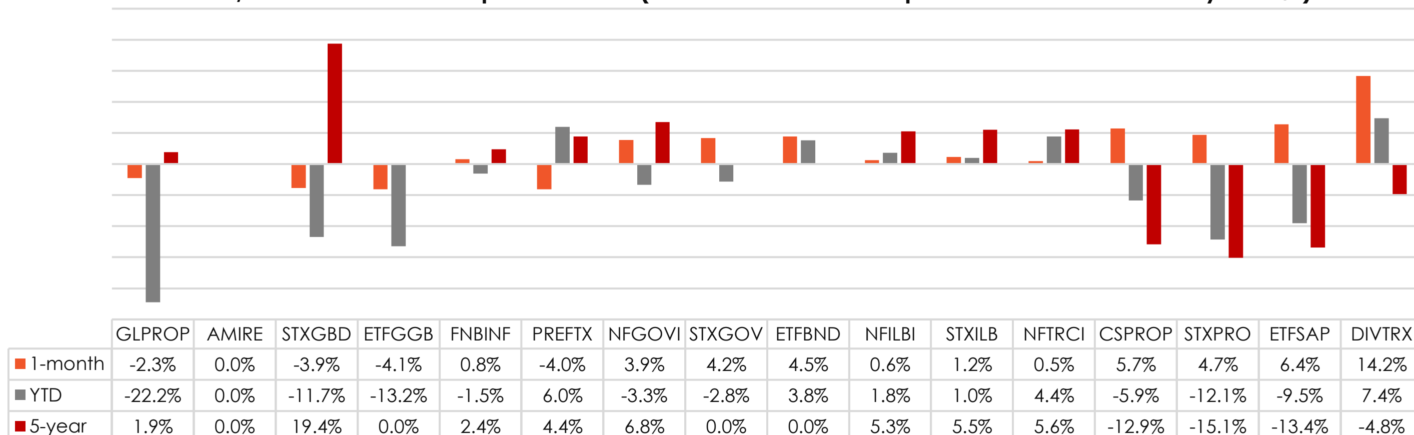
China's recent announcement of reduced lockdown restrictions should enable a better focus on the economy. Given the global economic slowdown, we also believe that gradually opening the economy will lead to more domestic activity in China, which would support company performance, earnings growth and share prices. Importantly, emerging market equities are quite cheap.

Global fund manager JP Morgan's proprietary valuation composite for emerging markets, which includes price-to-earnings, price-to-book and price-to-cash flow ratios, as well as dividend yield show that the asset class is trading significantly below its long-term average. Emerging market equities are also cheap relative to global equities.

As such, our satellite pick is the **Sygnia Itrix MSCI Emerging Markets 50 ETF** (+10.3%). The ETF tracks the performance of the MSCI Emerging Markets Investable Market Index (IMI). The index captures large, mid and small cap representation across 24 emerging markets (EM) with 3,207 constituents, covering approximately 99% of the free float-adjusted market capitalisation in each country.

Bonds and cash: Satrix SA Bond ETF (STXGOV)

Data from the SA Real Estate Investment Trust Association show that the short-term correlation (five years to end-November 2022) between SA



	GLPROP	AMIRE	STXGBD	ETFGGB	FNBINF	PREFTX	NFGOVI	STXGOV	ETFBND	NFILBI	STXILB	NFTRCI	CSPROP	STXPRO	ETFSAP	DIVTRX
1-month	-2.3%	0.0%	-3.9%	-4.1%	0.8%	-4.0%	3.9%	4.2%	4.5%	0.6%	1.2%	0.5%	5.7%	4.7%	6.4%	14.2%
YTD	-22.2%	0.0%	-11.7%	-13.2%	-1.5%	6.0%	-3.3%	-2.8%	3.8%	1.8%	1.0%	4.4%	-5.9%	-12.1%	-9.5%	7.4%
5-year	1.9%	0.0%	19.4%	0.0%	2.4%	4.4%	6.8%	0.0%	0.0%	5.3%	5.5%	5.6%	-12.9%	-15.1%	-13.4%	-4.8%

Given the ongoing cost of living crisis, global asset manager JP Morgan reports that the Office for Budget Responsibility in the UK expects real household incomes to drop by 7% over the two years to April 2024 – that's despite £100bn of government support.

After protests in late November, **China** has announced sweeping relaxations of its zero-Covid restrictions. These include the negative test requirement for entering public places and allowing citizens with mild cases to quarantine at home, instead of quarantine centres. However, the rise in infections and strict lockdowns has hurt the economy.

As the largest exporter of goods globally, the 8.7% annual slump in China's exports for November due to slowing demand and inflationary conditions firstly indicates how global factors are affecting the Asian giant. Locally, the effects of harsh lockdown conditions and rising infections are also evident – retail trade sales shrunk 0.5% annually in October 2022.

The categorical declines in home appliances (14.1%), building materials (8.7%), clothing (7.5%), furniture (6.6%) and cosmetics (3.7%) all reflect the broad-based drop in consumer demand. However, given the 26.6% rally in the Hong Kong-based Hang Seng index in November, we believe that equity markets are optimistic that Chinese authorities will turn their focus to stabilising the world's second largest economy on the back of relaxed Covid-19 restrictions.

Outlook and portfolio strategy

While inflation has shown signs of slowing in some major markets, it remains elevated in others. As such, most global consumers continue to face steep living costs, especially in emerging markets. In addition, JP Morgan expects steep interest rate hikes (to cool soaring inflation) to lead to an eventual slowdown in aggregate demand (housing, durable goods and then non-durable goods), the effects of which will be seen next year. In effect, the global fund manager expects moderate inflation and a mild recession.

bonds and the all share index is 0.44. Over the long-term (10 years to end November), this drops to a value of just 0.22. A negative correlation between asset classes is the best result, as the inverse co-movement of returns suggests that one asset class may outperform when another underperforms. Accordingly, we believe the data above reflect the benefits of portfolio diversification over the long term.

Consequently, our pick is the **Satrix SA Bond ETF** (+4.2%) which we think would be useful for portfolio diversification purposes. However, the recent spike in bond yields owing to load-shedding and the political fallout surrounding President Cyril Ramaphosa is a reminder that government bond yields and prices are sensitive to local political developments.

As such, the ANC leadership contest outcome at its elective conference next week and SA's fiscal policy in the lead-up to the 2023 budget and 2024 elections will have an influence on bond price movements.

Dividends: CoreShares S&P SA Dividend Aristocrats ETF (DIVTRX)

The CoreShares S&P SA Dividend Aristocrats ETF (+14.2%) is our pick for this month. We think that adding high dividend yield funds to ETF portfolios can be beneficial as a simple decomposition of the all share index's annualised 8.6% return over the last five years to end-November shows that the price proportion of return was 4.6% and that the income return from dividends was 4%.

With dividends/income making up almost 50% of the total return of the market, the simple decomposition of the all share index total return highlights the importance of dividends as part of an investor's returns. Furthermore, academic studies both locally and abroad find a strong relationship between dividends and the performance of share prices, further augmenting the usefulness of dividend yield as part of a portfolio strategy.

Supporting this view of a mild rather than deep recession is that while higher interest rates have slowed down demand, that a higher amount of mortgage/home loan owners in major economies such as the US and UK have fixed their rates to avoid the hit on disposable income from rising rates. Accordingly, only 5% of mortgages in the US were on adjustable rates (to-end-November) compared to over 20% in 2007. In the UK, this figure is at 14% compared to 70% in 2005, which was the last major tightening cycle.

Further supporting JP Morgan's core view of the global economy in 2023 are European efforts to increase gas supplies from the US (instead of major supplier Russia) for the winter season to cope with rising energy prices. This combined with a mild autumn has enabled gas storage to reach above-average levels, which is encouraging.

Locally, we expect the ongoing trend of relatively low public and private investment (due to slow policy reforms) to lead to continued weak real growth of the economy. As such, we expect low to mid-single digit growth in earnings of local companies. However, the most defensive and higher quality firms may generate higher earnings growth, as SA's local firms have had to adapt to the tough operational conditions in SA, which include crippling load-shedding.

From a broader equities perspective, the mostly tough 2022 provides one advantage – cheaper share prices. Accordingly, JP Morgan believes that recessionary fears have been priced into many shares. In addition, value shares – which tend to have low price:earnings ratios as well as high dividend yields – remain significantly cheap. However, the risk of inflation remaining higher for longer increases the risk of a deeper recession. As such, our ETF picks reflect our view of diversified core equity and ETF portfolios with a tilt towards value shares.

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