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Where to look for hidden opportunities

Among the possibilities to investigate are equities, bonds and commodities

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While the global economic outlook becomes increasingly cloudier, astute investors can still find opportunities amid the negative factors affecting markets.

“In our view, recent price declines have set the stage for an improved long-term investing environment,” says Debra Slabber, director: portfolio specialist at Morningstar Investment Management South Africa.

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Slabber believes that bonds in particular offer meaningful and positive return prospects after inflation.

“With real yields reaching 1.68% — their highest level since 2009 — we assign a medium conviction to the core US fixed income markets, including treasuries, corporates, and treasury inflation-protected securities.”

Jim Leaviss, CIO of public fixed investment at M&G Investments, also believes that global bonds, including government and corporate high- and low-quality options, now look attractive for investors, even with a recession looming.

“ Corporate credit is now trading at levels that offer very attractive spreads ”

- AJ Snyman

Based on current global bond market conditions, Leaviss says both government and corporate bonds now offer opportunities for investors to earn “super-normal” returns after the sharp sell-off in 2022.

“US dollar global investment-grade and high-yield corporate bonds were trading at their highest yields in 10 years, with investment-grade five-year bonds yielding 4.8%, compared with only 2% last year. Meanwhile, high-yield corporate bonds (those with credit ratings of BB or lower) were offering about 9%,” says Leaviss.

The 2022 selloff also improved broad equity market valuations, which offers numerous opportunities for growth. While emerging market stocks experienced broadly negative year-to-date returns, especially in US dollar terms, Slabber says absolute and relative valuations have improved.

“Given our assessment, the fundamental risk picture and contrarian elements, we conclude that this asset class merits an upgrade in our overall conviction.”

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Sector-specific opportunities exist in commodities, says Peregrine Capital investment analyst AJ Snyman, as underinvestment over the past five years has created supply constraints that will likely persist for a while.

“The stage is set for a larger commodity boom. Capital from both governments and the private sector could plausibly flow into commodity-related markets, such as the energy sector in Europe.”

Investors should also look at companies that, by virtue of their competitive advantage and business model, are able to pass on inflation and still grow in real terms, suggests Snyman.

“Companies such as Visa and Mastercard have large and enduring moats and offer attractive defensive properties, which places them in a better relative position to weather the impact of a recession and offer a hedge against rising inflation.”

“ Bonds offer meaningful and positive return prospects after inflation ”

- Debra Slabber

From a local market perspective, Slabber says South African equities are attractive across the board, with resources, financials and industrials offering good opportunities.

“On an absolute basis, SA equities are now priced at their cheapest levels since 2008, when measured using the cyclically adjusted p:e.”

Domestically, the banking sector stands to gain from the endowment benefit related to the faster rate hiking cycle.

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“All banks have very healthy capital ratios and investors could still see decent growth in this sector, with most banks trading below eight times their one-year forward earnings, with dividend yields at 8%,” says Snyman.

In relation to alternative assets, Snyman identifies opportunities in corporate credit, which is now trading at levels that offer very attractive spreads after experiencing one of its worst years in decades.

RMB Corvest CEO Mike Donaldson says private equity is another area with significant potential, especially those looking to diversify offshore, even without double-digit economic growth.

“Level-headed deals will deliver returns from structure and cash flow, and can still perform nicely in the low-growth environment that is likely to persist over the next few years.”

But Donaldson does not expect the deal flow seen in 2022 to continue into 2023, as the market experienced an abnormal post-Covid spike in activity after three years of subdued dealmaking.

“Inflation will also start to affect company earnings and consumer spending, which will affect portfolios.”

However, the normalisation in asset prices from the inflated multiples seen since 2016 and 2017 should offer local investors good returns, even at current exchange rates, he explains.

“From a local perspective, infrastructure development will likely emerge as a major private equity target in 2023 and beyond as banks broaden their environmental, social and governance offering and project finance spearheads SA’s much-needed transition to renewable energy.”

Given the prevailing opportunity set, Snyman suggests that hedge funds are ideally positioned to generate returns.

“By adopting a nimble and unconstrained approach with a willingness to look in places that others aren’t, while applying appropriate hedges to lower volatility, hedge funds can generate superior and uncorrelated returns,” he says.

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