NEWSLETTER

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IN THIS MONTH'S NEWSLETTER

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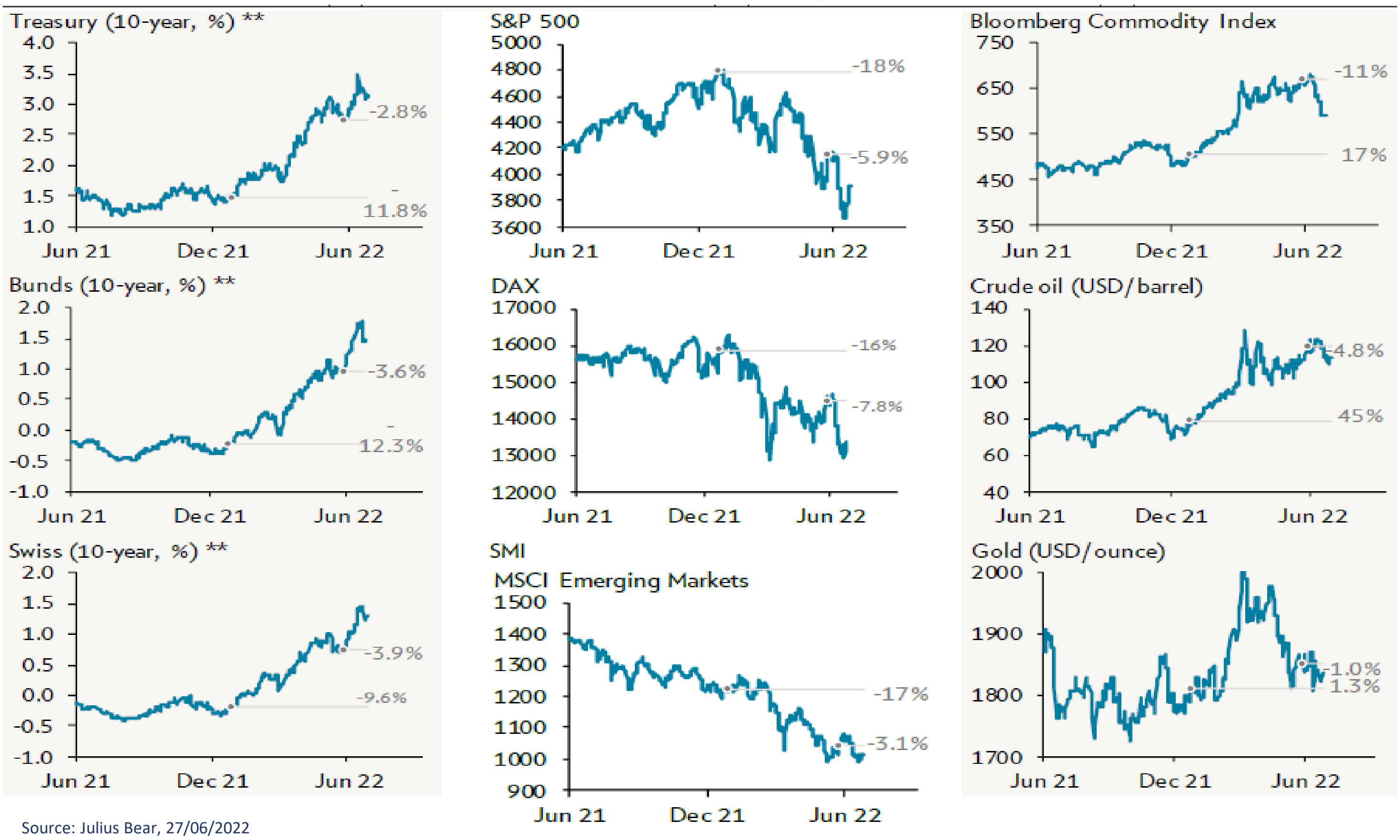
- Share focus: Microsoft
- Graph of the month

"Reality is one of the possibilities I cannot afford to ignore"

- Leonard Cohen, Beautiful Losers

MARKET OVERVIEW

Review (1-month and 6-month performance)



Source: Julius Bear, 27/06/2022

INTERNATIONAL

	Last	Month %	YTD %	5Y ann. %
MSCI World	2546	-8.77	-20.28	8.25
S&P 500	3785	-7.70	-20.58	11.29
NASDAQ 100	11029	-8.05	-29.51	13.51
EURO STOXX 50	3455	-9.88	-19.45	3.27
MSCI EM	1001	-5.96	-17.56	2.51
HANG SENG	21860	3.48	-6.57	0.01
US Equities Volatility Index (VIX)	28.71	3.02	11.49	11.18

The first half of 2022 will be remembered as the worst start to a year for equity market investors in decades. The S&P index dropped 21% since the start of the year, its worst performance since 1970. The bell-weather index lost 16.5% during Q2. The Nasdaq is down 30% YtD, the worst hit since 2002. During Q2 the Nasdaq lost 22% as investors switched out of growth stocks into more defensive counters. Equity markets in Europe and Japan did not escape the selling pressure either – both regions lost 15% since the 1st of April. The MSCI World USD Index recorded a -8.8%% m/m return (-15.6% y/y).

Market sentiment is still dominated by concerns that central banks were caught off-guard by accelerating inflation. Rising interest rates and the subsequent downward revisions for global economic growth weighed on both equity and bond markets. Key drivers to the high inflation numbers were surging energy and food prices. These prices remain stubbornly high due to geopolitical tensions and lower than expected grain crops in the northern hemisphere. The Federal Reserve's preferred inflation measure, core personal consumption expenditure rose to 4,7% in May. This was slightly less than expected and also lower than the previous reading. This might be the first indication that inflation in the US may have peaked.

The Federal Reserve raised the Fed rate by 75 bps in June to 1.75%. Currently the market is discounting another 100bps increase before the end of the year. There are growing worries that the Fed's efforts to contain inflation will result in an economic recession.

Europe is committed to substantially reduce its dependance on Russian energy by 2027. Russia slowed gas supplies to Europe during June. Germany received only 40% of the gas it requested.

SOUTH AFRICA

	Last	Month %	YTD %	5Y ann. %
JSE All Share	67747	-7.97	-10.16	8.74
JSE Resources	63748	-18.31	-10.18	21.65
South Africa 10Y Bond	10.56%			
Net Foreign Equity Flow	-R24.9bn			
Net Foreign Bond Flow	-R33.4bn			
USDZAR	16.3731	5.12	2.17	-4.10
USDEUR	17.1058	2.17	-5.89	-2.30

After a decent Q1 the JSE All Share index pulled back by 20% during Q2. Year to date the index is down 10.2%. Non-residents remain net sellers of SA Inc. The cumulative equity market outflow for the last 12 months is R131.6bn. Foreign sentiment towards the local bond market is also fragile. In June non-residents were net sellers of bonds valued R33.4bn, notably higher than May's R19bn outflow (according to Bloomberg data). This brings the cumulative outflow for the last 12 months to R288.4bn.

The fact that the national electricity grid is under enormous pressure was recently confirmed by the implementation of stage 6 black-outs. This is the second time Eskom had to resort to this drastic step. To add insult to injury, the ongoing wage dispute between Eskom and its staff is placing additional strain on the system with the representative labour union asking for the Minister of Public Enterprises to intervene, like in 2018. Over the last three months South Africans experienced 47 days of load shedding.

South African inflation reached 6.5% in May. This is the highest reading since 2017 and has breached the SA Reserve Bank's Monetary Policy Committee's upper limit of its inflation targeting range of 6%. Fuel prices are 32.5% higher than a year ago.

Over the last few months elevated resource prices and lower domestic demand contributed to a trade surplus. South Africa's trade surplus increased to ZAR 28.35 billion in May from an upwardly revised ZAR 16 billion in the previous month. This helped the ZAR to remain relatively steady against the backdrop of a strong US dollar. However, the risks are increasing for a weaker ZAR towards the end of the year.

It looks like European gas shortages are unlikely over the next few months, as consumption declines during the summer. However, concerns are mounting that Europe might face shortages in the winter. Over the last year inflation in Europe increased at a faster pace than the US, mainly as a result of runaway gas prices. The European Central Bank is expected to end its asset purchases in the 3rd quarter and increase interest rates by a substantial 175 bps by the end of the year.

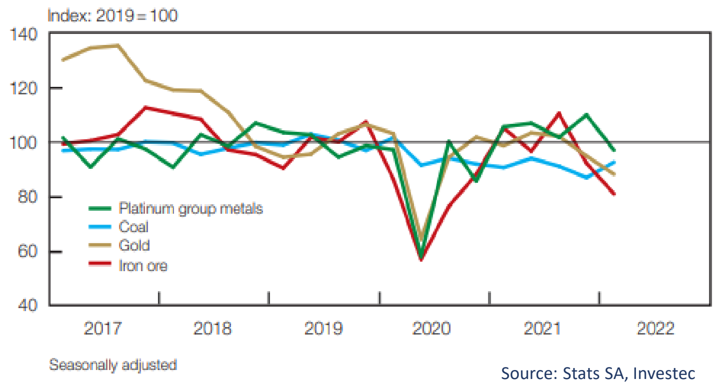
In China a new Covid outbreak spooked markets. The Chinese government's zero Covid policy did the global supply chain no favors. Indications that we've seen the worst of regulatory tightening regarding Chinese technology firms were well received by the markets.

Outlook

Looking ahead, the upcoming earnings season will be a challenging one, with disappointments from single companies having the potential to weigh on the overall market sentiment. Negative earnings revisions are likely. However, a lot of negativity is already priced into the market. Analysts have lowered their Q2 earnings estimates for the S&P 500 to 4.6% (down from 5.9% at the beginning of the quarter) to reflect the more challenging macroeconomic backdrop. Unsurprisingly, investors will continue to focus on margins in the upcoming earnings season.

So far, corporates have been able to pass on the higher costs by raising prices, thereby protecting their profit margins. Currently, consensus expects S&P 500 profit margins to further increase to 12.4% for the second quarter (Q1: 12.3%), which seems harder to achieve given the continued rise in inflation alongside falling sentiment indicators, especially on the consumer side. Now more than ever emphasis should be placed on investing in quality companies with strong balance sheets, that generate high free cash flow and has strong pricing power.

Figure 1: Physical volume of SA mining production



Source: Stats SA, Investec

The Bloomberg commodity index is now 16.7% off recent highs and concerns regarding Eskom and falling mining exports (due to failing infrastructure) are adding to the ZAR's headwinds. In the political arena the long knives are out for President Ramaphosa who is facing serious various allegations regarding the potential contravention of SAID and SARB regulations.

On a more positive side, the Naspers/Prosus group published its results Monday 27 June. The announcement regarding a huge share buyback to narrow the discount to its NAV was well received by the market. Naspers and Prosus recorded gains of 42% and 33% respectively for the month.

Outlook

With commodity prices losing steam as a result of lower international growth expectations and depressed global and local investor sentiment we expect challenging conditions ahead for financial markets.

Market risk may be reduced by including structured products to portfolios. Structured products have the potential to limit downside risk and enhance returns when markets are trading sideways. For more information contact your portfolio manager.

Figure 2: June 2022 Top 5 best and worst performing international and South African shares

Best performing	%	Worst performing	%
Alibaba	+18%	Pilbara Minerals	-24%
Boeing	+4%	Booking Holdings	-22%
AbbVie	+4%	Albemarle	-20%
Eli Lilly	+3%	Nvidia	-19%
Costco	+3%	Partners Group	-17%

Best performing	%	Worst performing	%
Naspers	+42%	Hammerson PLC	-31%
Prosus	+33%	Anglo American	-24%
Mediclinic	+21%	Sanlam	-22%
Alexander Forbes	+10%	Sirius Real Estate	-22%
Datatec	+10%	Sibanye Stillwater	-20%

Source: FactSet, IRESS

Company Overview

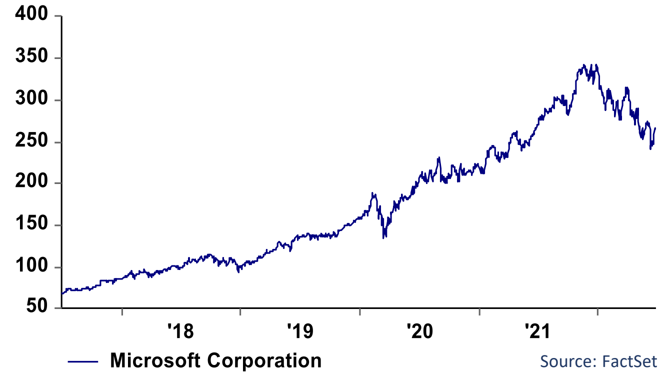
Microsoft develops, manufactures, licenses, sells and supports software products. The company operates through the following business segments: Productivity and business Process, Intelligent Cloud, and More Personal Computing. It is best known for Windows, Office 365, LinkedIn, Azure and Xbox. Microsoft most recently acquired Activation Blizzard, a leading videogame publisher, for a staggering $68.7 billion. Valued at over $1.9 (R30.6) trillion, it is currently the third-largest company in the world. It is comparable to the market capitalization of the entire Johannesburg Stock Exchange (JSE), which weighs in at $1.36 (R21.9) trillion.

Its recurring revenue model, large user base, and variety of products are Microsoft's greatest strengths. Microsoft Office enjoys a near monopoly in office productivity software and is indispensable to many companies. Office 365 offers various monthly packages ranging from $6 to $35 per user per month and has already more than 165 million subscribers. LinkedIn, a professional networking tool, is at its core a free-to-use networking application similar to Facebook with 145 million Monthly Active Users (MAU) and is growing by more than 30% annually. For professional networking, we believe that no comparable platform exists. Finally, Microsoft Azure is the centerpiece of the new Microsoft. Azure's competitive advantage offers customers a painless way to experiment and move select workloads to the cloud creating seamless hybrid cloud environments. Azure also is an excellent launching point for secular trends in AI, business intelligence and Internet of Things (IoT), as it continues to launch new services centered around these broad themes. We estimate revenue from Azure itself is a mid-to-high single-digit percentage of revenue, growing by more than 75% annually.

Valuation

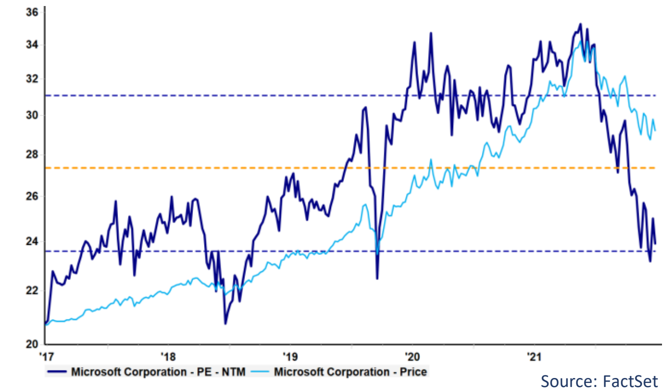
Microsoft shares are down -22% YtD, in line with the broad market. The shares remain attractively valued with a forward P/E ration of 25x, which is below the 5-year median of 27.6x. We model a 5-year compound annual growth rate, or CAGR, for revenue of approximately 13%. Judging only on the basis of P/E multiples, Microsoft appears to be expensive. However, if we also consider the company's growth outlook, the stock is arguably cheap – not only in comparison with FAANG but in comparison with the S&P 500. Microsoft also have a very strong balance sheet with a net cash position of $48 billion (cash – total debt).

Performance



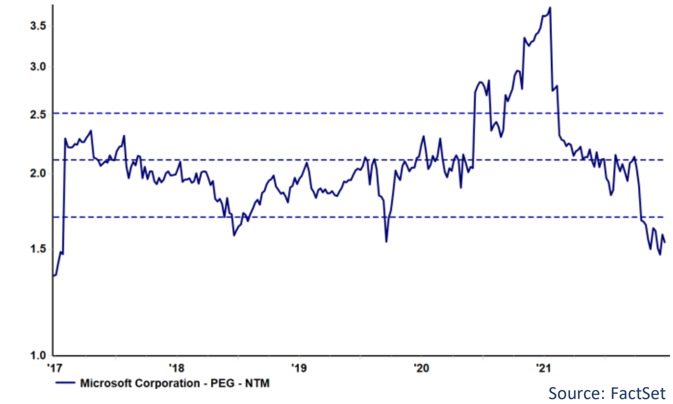
Source: FactSet

12-month forward P/E



Source: FactSet

12-month forward PEG



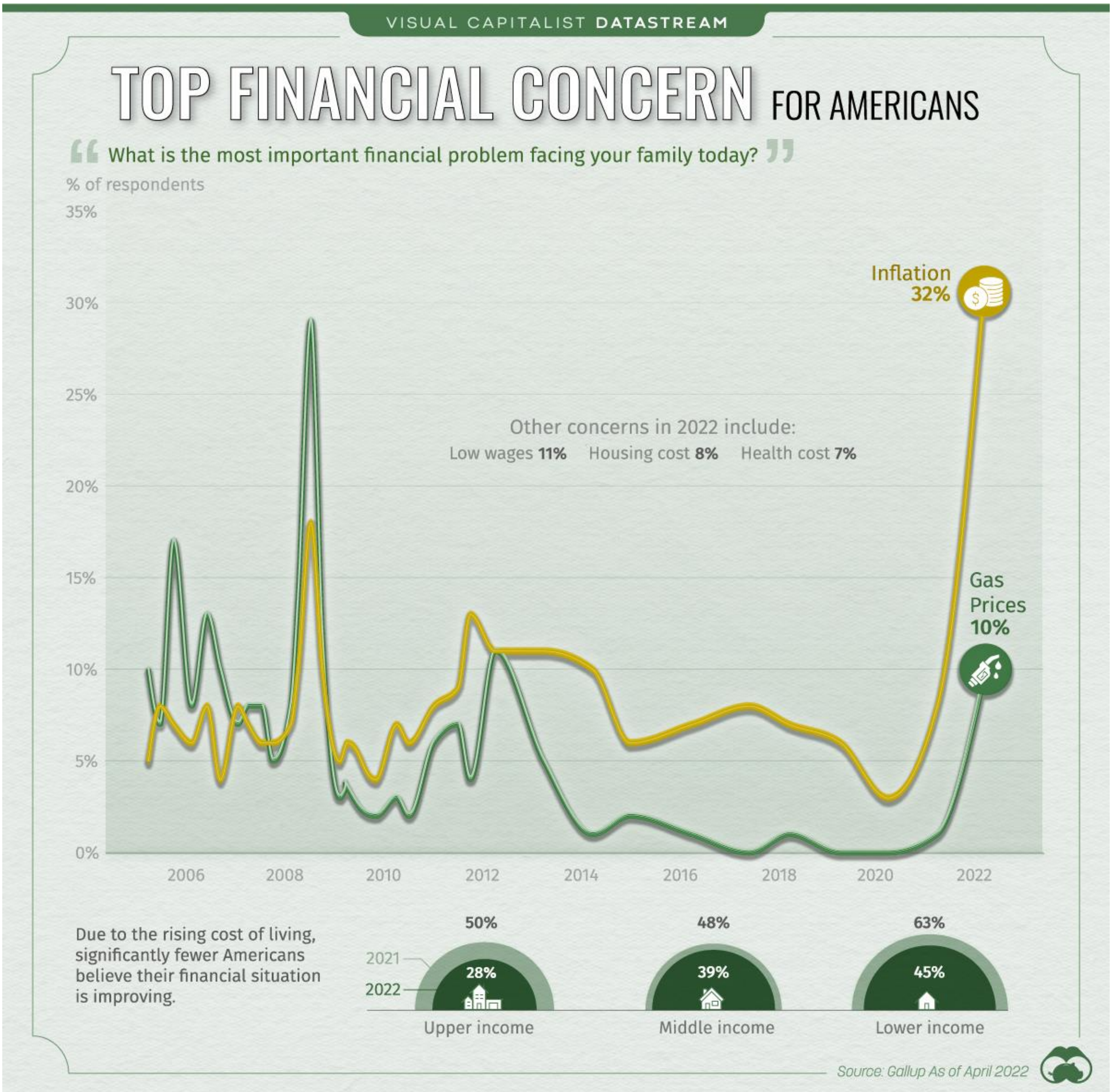
Source: FactSet

Financials

	2020	2021	2022E*	2023E*	2024E*
Sales (USDm)	143 015	168 088	199 112	227 405	258 195
EBIT (USDm)	52 959	69 916	84 087	96 459	111 464
EBIT Margin (%)	37,03	41,59	42,23	42,42	43,17
EV/EBITDA (x)	28,06	22,62	18,87	16,11	13,51
EPS (USD)	5,76	7,97	9,28	10,78	12,51
EPS growth (%)	20,88	38,37	16,42	16,18	16,00
P/E (x)	44,53	32,18	27,64	23,79	20,51
P/B (x)	16,64	13,63	10,91	9,26	7,48
Dividend yield (%)	0,80	0,87	0,96	1,04	1,16

Source: FactSet

GRAPH OF THE MONTH



Source: Visual Capitalist

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