NEWSLETTER

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IN THIS MONTH'S NEWSLETTER

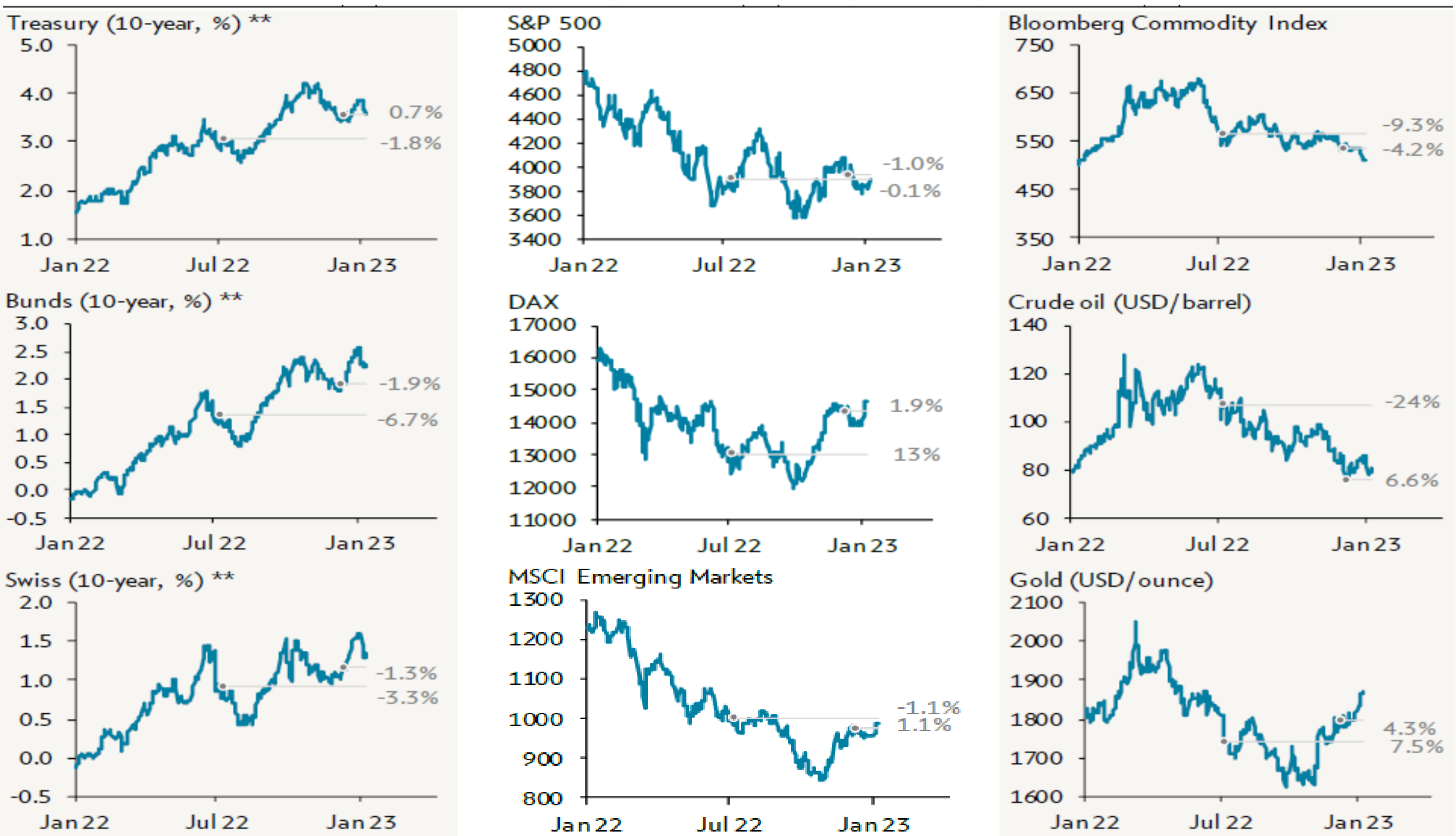
- Market overview
- Graphs of the month
- Share focus: Adobe

"When it is dark enough you can see the stars"

- Ralph Waldo Emerson

MARKET OVERVIEW

Review (1-month and 6-month performance)



Source: Julius Bear, 09/01/2023

	Last	Month %	YTD %	5Y ann. %
JSE All Share	73049	-2.81	4.45	3.97
JSE Resources	70805	-3.58	6.21	13.33
South Africa 10Y Bond	10.17%			
Net Foreign Equity Flow	-R18.3bn			
Net Foreign Bond Flow	-R12.9bn			
USDZAR	16.9831	-0.05	-7.09	-6.60
EURZAR	18.1057	-3.12	-0.65	-4.21

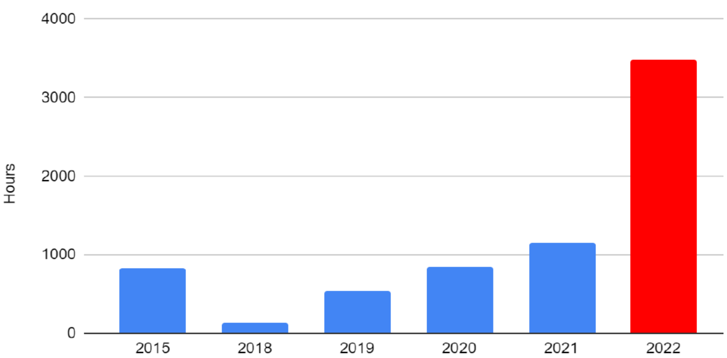
Source: RMB

South African equities declined in December by 2.8%, but were still up 4.5% **in 2022**. Non-residents remain net sellers of SA Inc. The cumulative equity market outflow for the last 12 months is **R90bn** and the cumulative bond outflow for the last 12 months to **R259bn** (according to Bloomberg data).

President Cyril Ramaphosa secured a second term as head of the ANC, bringing him closer to clinching a second term as president of South Africa when the country heads to the polls in 2024. He must now navigate a myriad of challenges facing the country, most urgently the **worsening electricity crisis** and the uncertainty at Eskom and the rot at municipalities. The resignation of Eskom CEO André de Ruyter's is a huge setback for the state-owned power utility and South Africa. This is one of the **biggest risks** we face as it comes at a time when the utility, which produces 95% of the electricity used in the country, needs stable leadership.

Not only does load shedding weigh heavily on **growth forecasts**, but it also damages corporate and consumer confidence. The following table illustrates the alarming trend in load shedding hours per year.

Figure 1: The number of load shedding hours per year



Source: Brenthurst Foundation

South Africa remains a small, open economy and will be negatively affected by weakening global growth. Most urgently, the president needs to address deficiencies in electricity, rail and ports, as well as water infrastructure, which are prerequisites to economic growth and stability as well as sustainable state revenues and debt levels. The South African **outlook** remains weak and **growth estimates** have been reduced for 2023.

Figure 2: South Africa economic outlook forward PE

National Accounts	CY '21	CY '22	CY '23
Real GDP (%)	4,9	1,8	1,5
Household Consumption (Real, %y/y)	5,6	2,5	1,6
Inflation			
CPI (%y/y)	4,6	6,9	5,6
Other Indicators			
Unemployment Rate (%)	34,3	34,8	34,8
Budget Balance (% of GDP)	-5,5	-6,0	-4,9
Interest Rates			
Repo Rate	3,75	7,00	7,63

Source: Factset

Outlook

What must we be mindful of in 2023 and where are the opportunities?

- Our market appears **very cheap** on an absolute and relative basis which could be a good entry point for investors.
- The recent collapse in fertilizer prices, weaker ZAR, decent soft commodity prices and decent rains lead us to believe that we are in for another **bumper agri year**.
- A number of emerging markets (EM) were quick to raise rates and could potentially benefit from an **early unwind** as inflation looks to be softening quicker than expected.
- The easing of **China's** zero-Covid policy, coupled with a **weaker dollar** could be a potent cocktail for EM, including South Africa.
- The **energy reform** narrative continues to trek along in the right direction. There's an upside for our market if the pace of execution picks up.
- We should see **inflows in our local market** for 2023, but this is likely to start in the fixed-income space and only migrate into equities towards the end of the year.

That said, valuations have markedly improved and EM debt now seems to be **pricing in** known risks and, as such, could offer attractive return potential for long-term investors. The JSE is 1 std. deviation cheaper than EM and EM is 1 std. deviation cheaper relative to developed markets (DM). The JSE All-Share index forward PE is currently trading at an **18% discount** to its 15-year long-term average.

Figure 3: JSE All-Share index 12-month forward PE

Source: RMB

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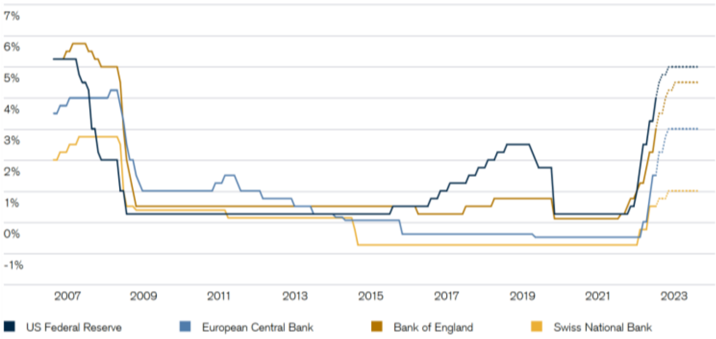
	Last	Month %	YTD %	5Y ann. %
MSCI World	2603	-4.2	-17.7	3.83
S&P 500	3840	-5.9	-19.4	6.96
NASDAQ 100	10940	-9.1	-33.1	10.46
EURO STOXX 50	3794	-4.3	-9.5	1.01
MSCI EM	969	-1.6	-22.4	-0.89
HANG SENG	19781	6.4	-15.5	-8.48
US Equities Volatility Index (VIX)	21.67	-5.3	25.8	11.26

Source: Edmond De Rothschild

Lower inflation expectations, a tight monetary policy as starting point and weaker economic growth make 2023 the exact opposite of 2022 in terms of monetary policy. 2022 truly marked the end of the lower-for-longer era as central banks hiked interest rates at the fastest pace since 1979.

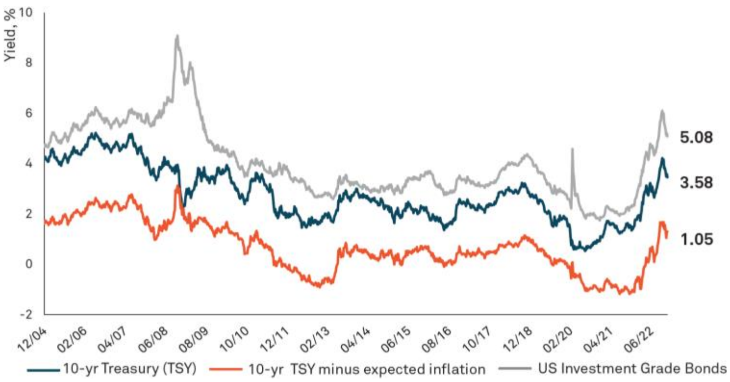
Figure 4: Central bank rates and forecasts



Source: Bloomberg, Credit Suisse

The US Federal Reserve remains hawkish and signaled 2 more rate hikes in 2023 after hiking rates by 425 bps in 2022. US Treasury bonds and US Investment grade bonds are offering real yields of between 1% and 3% (**figure 5**). The hawkish Fed and attractive bond yields should support the very strong USD. The probability of a recession in the **US** remains high, but this is not our base case. Tighter financial conditions are leading to a pullback in cyclical spending, namely goods consumption and housing, but healthy balance sheets and a resilient labour market should act as a buffer against an outright downturn. US equities saw a sharp de-rating in 2022 as the Fed increased its policy rate significantly. The US equity market still offers a relatively stable earnings picture but trades at a premium to the rest of the world. Once the market starts pricing in a less hawkish Fed, US equities should start to recover.

Figure 5: Bond yields at its highest levels in a decade



Source: BNY Mellon

Figure 6: US tightening cycle journey

We believe the recession in the **Eurozone** started in Q4 2022 and will persist until late Q1 2023, with a peak-to-trough fall in GDP of about 1%. Fiscal policy support, resilient labour markets and high savings should mitigate the depth of the downturn, but the risks are to the downside amid uncertainty over gas supply. Headline inflation may be peaking but is likely to decline only gradually as price pressures have broadened and wage growth has gained momentum. We expect persistently high inflation and currency weakness to push the European Central Bank to hike rates aggressively to a terminal rate of 3% by early 2023. In our view, rate cuts are unlikely in 2023.

The **Chinese** economy has been faced with an entirely different set of challenges to the developed world with widespread lockdowns still in place to contain the spread of Covid-19. Normalisation of the Chinese economy could significantly ease the supply chain disruptions that have contributed to rapidly rising goods inflation. Although a rebound in growth in China could also boost demand for global commodities, we think that the net effect will be deflationary.

Themes for 2023:

1. An end to rate hikes as inflation peaks;
2. Global growth is decelerating and with monetary policy in the restrictive territory, economic growth should remain weak throughout 2023;
3. De-globalization will start to play a larger role. Global trade as a share of GDP will decline and strategic sectors will be repatriated to their countries of origin.

Bonds versus Equities in 2023

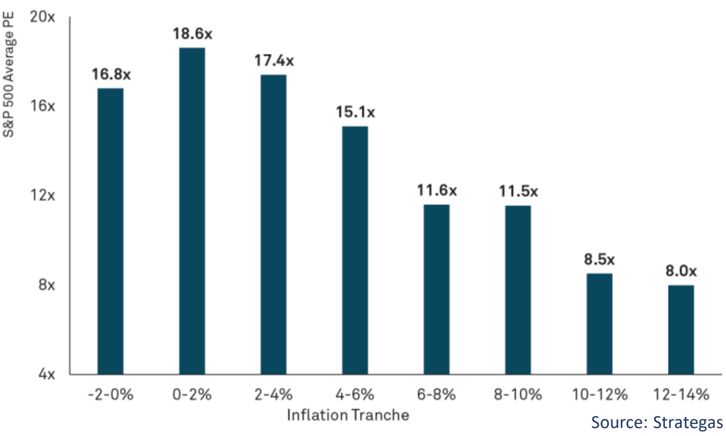
Higher **inflation** and rising **interest rates** lower the prices of bonds and equities. This is because future cash flows are discounted at a higher rate. Thus, higher inflation uncertainty should trigger larger synchronized swings in the discount rates of equities and bonds, which results in an increase in the correlation between equities and bonds and in turn reduces the diversification potential of bonds. This is what happened during the last two years. **Growth** on the other hand primarily affects equities, via a depressed earnings growth outlook and lower expected dividends. Bonds will in most instances benefit from slowing growth as yields fall on the back of lower inflation expectations and ultimately looser monetary policy.

The most probable scenarios for 2023 are:

1. Low growth to no growth environment with lower inflation and constant or decreasing interest rates (recession + slowing inflation). This scenario should see bonds outperform equities.
2. US avoids a recession and the Eurozone and UK enter a mild recession, while inflation slows and interest rates stay constant or decrease. Both bonds and equities should benefit from the scenario. Equities should outperform bonds.
3. Inflation persists and central banks decide to remain hawkish for the whole of 2023. This scenario will see equities and bonds extending losses. This is similar to what happened in 2022 and cash will be the only place to hide.

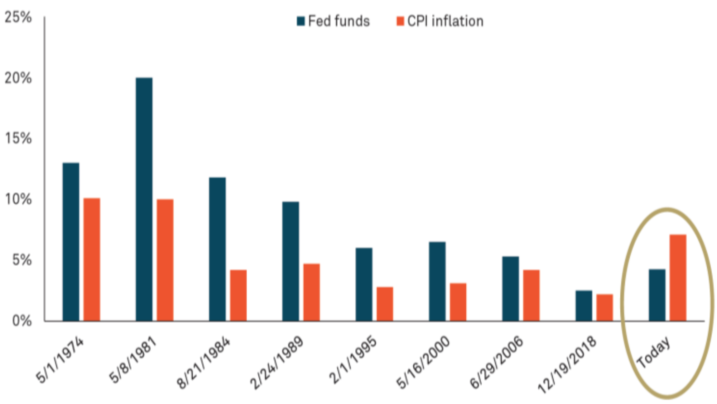
Even if we enter a global recession in 2023 it is still possible to produce reasonable returns. The main risk is that inflation does not subside meaningfully. **Figure 7** shows the impact that inflation has on equity valuations. Higher inflation pushes down equity valuations. **Figure 8** illustrates that the Fed has always ended a hiking cycle with a Fed funds rate that exceeds inflation. High inflation is a very serious risk to all asset prices. We share the view that the Fed will not stop hiking if inflation is not under control even if it means entering a recession.

Figure 7: Impact of inflation on multiples



Source: Strategas

Figure 8: Fed funds rate and inflation (%) at the end of prior tightening cycles

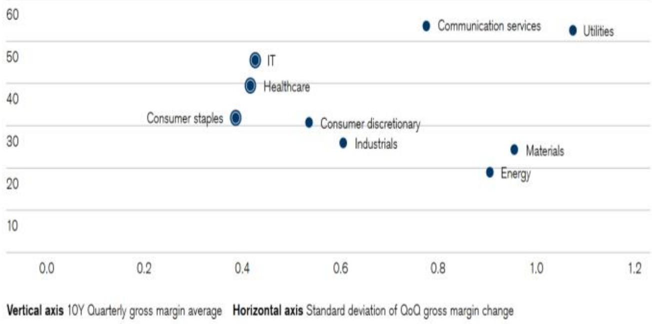


Source: Strategas

We think that the worst of the de-rating (**figure 10**) is behind us however, a significant re-rating of equities would require a shift in central bank rhetoric. We expect a turning point in the market to materialize in the second half of 2023. Until then, we expect volatile but rather muted equity returns. Our primary focus remains on defensive sectors with stable margins, strong pricing power and low leverage. The following sectors look to be best suited for the current conditions (**figure 9**): IT, healthcare and consumer staples.

The vertical axis on the graph shows the average quarterly gross margin over the last 10 years and the horizontal axis plots the standard deviation of those quarterly gross margins. Consumer staples have the lowest standard deviation in quarter-on-quarter gross margin change, meaning that their gross margins are the most stable, exhibiting strong pricing power. Once we get closer to the point of a pivot, we think that it will be best to rotate to interest rate sensitive sectors like growth companies. From a valuation point, global equities seem to be fairly valued. A mild recession looks to be priced into current valuations.

Figure 9: Pricing power of various sectors



Source: Refinitiv, Credit Suisse

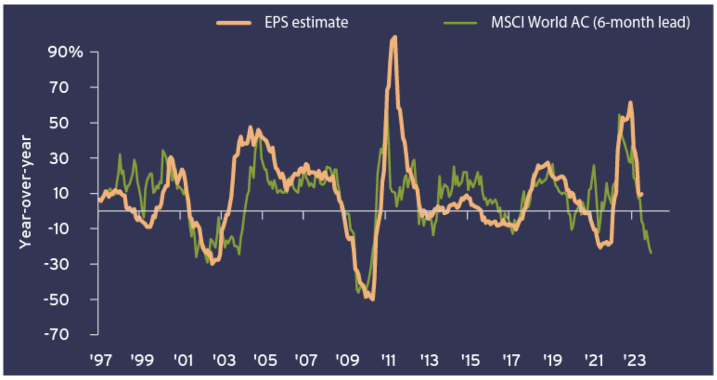
Figure 10: MSCI ACWI forward P/E ratio

Source: RMB

INTERNATIONAL

If central banks' error at the beginning of 2022 was to underestimate the need to normalise monetary policy away from a stimulative stance, so their potential mistake could in 2023 be to misjudge how swiftly the economy and thus inflation, reacts to a restrictive monetary policy stance. We acknowledge that the near-term macro outlook is unusually uncertain. But regardless of what 2023 brings, we believe the inflation, growth, and geopolitical factors that have caused market strife in 2022 are increasing the potential rewards for medium- and long-term investors willing to navigate these risks. **Markets are forward-looking and will start discounting a recovery in earnings before it actually happens.**

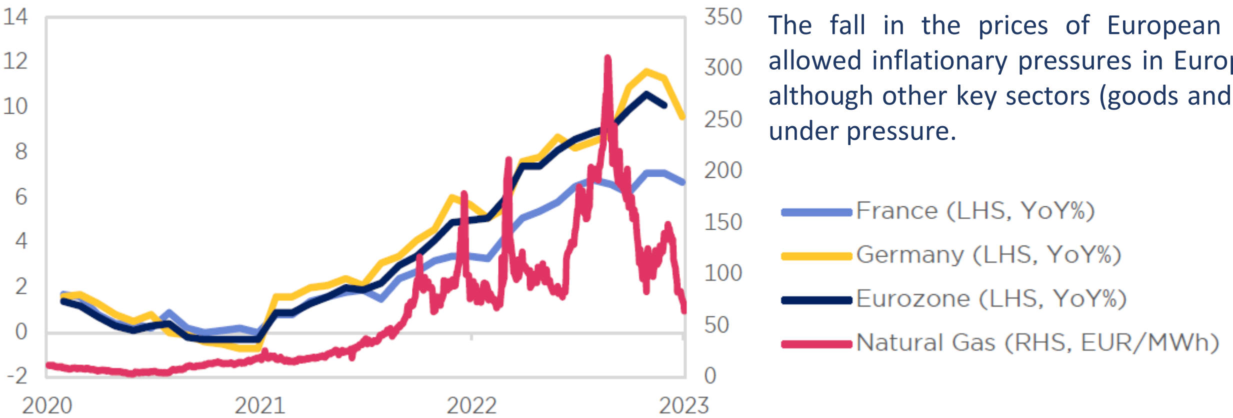
Figure 11: Earnings per share bottom later than markets



Source: Haver

GRAPHS OF THE MONTH

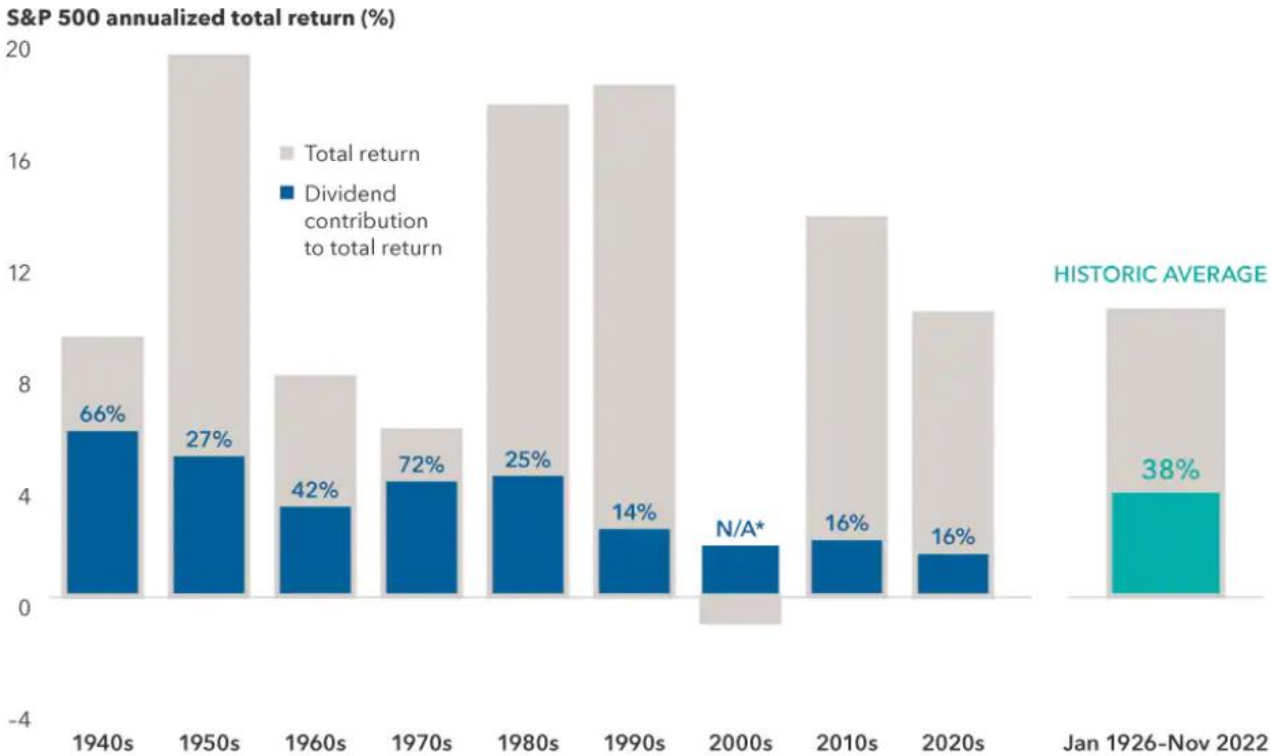
Figure 12: Annual change in German, French and European consumer price indices in relation to European natural gas prices, since 2020



Source: Edmond de Rothschild

The fall in the prices of European natural gas has allowed inflationary pressures in Europe to decelerate, although other key sectors (goods and services) remain under pressure.

Figure 13: Dividends have historically been a larger percentage of total return



Source: Capital Group

Company Overview

Adobe dominates the content creation space. It has proven to be a true market leader with software like Photoshop and Acrobat PDF. Adobe consists of 3 segments: 1) Digital Media 2) Digital Experience and 3) Publishing and Advertising. Digital media makes up around 75% of total revenue. More than 90% of the total digital media revenue is subscription-based revenue. Making it much more predictable. This segment contains Creative Cloud (nearly 50% of revenue) and Document Cloud (10% of total revenue). Both product groups generate strong revenue growth however, revenue growth in Creative Cloud is much higher. The Creative Cloud consists of Photoshop, Illustrator, InDesign and Premier to name a few.

In the current economic environment companies are experiencing some headwinds in the form of inflationary pressure on input costs and increased cost of debt. These factors will start to put pressure on margins if the company struggles to pass those costs on to the consumer. Adobe is very well-positioned to navigate through these times. Adobe has a net cash position meaning that it can pay off debt if the cost of debt increases by too much and it earns most of its revenue through subscriptions. Subscription revenue allows Adobe, much like Microsoft, to increase subscription fees every year to combat inflation and offers significantly improved revenue visibility. This model also makes it more accessible for a wider client base because instead of paying large up-front fees, clients can get access by paying smaller monthly fees.

Adobe enjoys a relatively wide moat because of the high switching cost of its products. Adobe's Creative Cloud is so pervasive within the creative world and the educational system that replacing it would be an insurmountable barrier. Nearly all creative professionals use Adobe's software, forcing all other professionals to also use it. Because its software is so widely adopted, hundreds of plug-ins from third-party developers are available. Adobe should also enjoy relatively frictionless cross-selling opportunities.

We believe continued innovation, gathering new users, and upselling existing users in Creative Cloud should drive strong growth for the next several years.

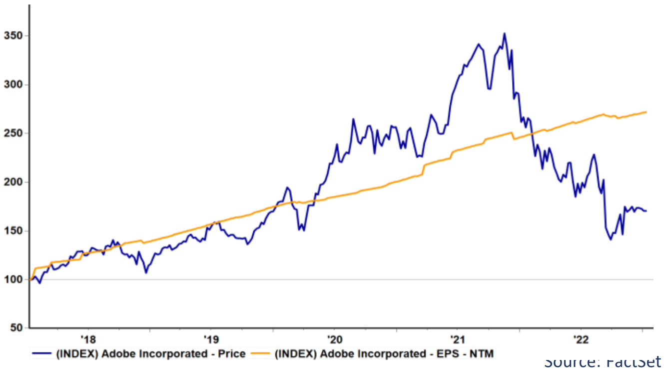
Valuation

Current Price: USD 332

Target Price: USD 377

		Free Cash Flow multiple				
		16	18	20	22	24
Discount rate	8%	374	410	446	482	518
	10%	344	377	409	442	475
	12%	317	347	377	407	437
	14%	292	320	347	375	402
	16%	270	295	321	346	371

Figure 14: Performance

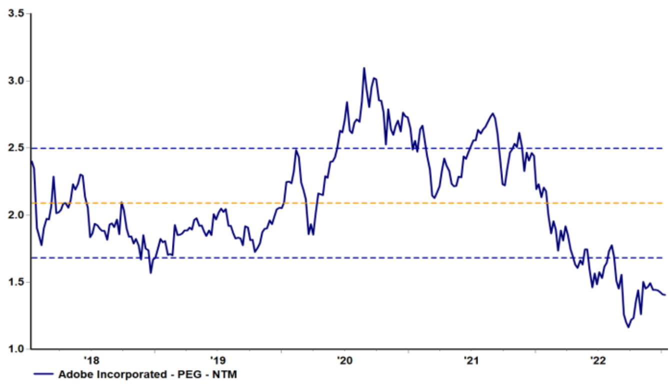


Source: FactSet

Figure 15: 12-month forward P/E

Source: FactSet

Figure 16: 12-month forward PEG



Source: FactSet

Figure 17: Financials

	2020	2021	2022E*	2023E*
Sales (USDm)	12,868	15,785	17,662	20,030
EBIT (USDm)	5,521	7,259	7,933	9,018
EBIT Margin (%)	42.90	45.99	44.92	45.02
EV/EBITDA (x)	36.36	39.55	16.58	14.33
Adjusted EPS (USD)	10.10	12.48	13.61	15.81
EPS growth (%)	28.34	23.56	9.04	16.19
P/E (x)	39.68	44.11	22.72	19.55
P/B (x)	17.28	21.50	-	-
Dividend yield (%)	-	-	-	-
Net debt/equity (%)	-9.68	-7.60	-	-

Source: FactSet

SHARE FOCUS

Adobe

CONTACT US

Francois Du Plessis, CFP

082 492 9199

fduplessis@vegacapital.co.za

Louis Storm, CFA

083 552 2343

lstorm@vegacapital.co.za

Abrie Smit

082 087 0883

asmit@vegacapital.co.za

SOURCES

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