AMPLIFY

Amplify SCI* Absolute Fund

Fund Commentary

January 2021

Carmen Nel

Economist and Macro Strategist

Matrix Fund Managers

> ... SA earnings growth should be underpinned by the strong global trade rebound ...

*Sanlam Collective Investments
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Overall

For many, January felt like a particularly long month. Health care workers were pressured by resurgent Covid-19 cases and the confirmation of three new, more virulent variants of the coronavirus in Brazil, the UK, and South Africa. Politicians had to ponder the severity of renewed lockdowns, continuing to balance lives versus livelihoods. And many working parents had to share the Zoom rooms with their children as the opening of schools was delayed.

Markets tracked sideways in January

Markets mostly tracked sideways in January as supportive factors, such as easy money and stimulus, were countered by the uneven vaccine rollout and the tiff between day traders and hedge funds. A reality check was probably in order. The vaccine rollout was always going to be uneven for various reasons, even if much of the good news was in the price. At best, developed countries were expected to achieve some semblance of herd immunity during the second half of 2021, while many emerging countries would lag substantially. This has not changed. South Africa managed to procure various vaccines, but the efficiency of the rollout and vaccine efficacy (in the context of the new strain) remain highly uncertain.

In the US, substantial fiscal stimulus is expected

The Democratic victory in the US means that substantial fiscal stimulus is likely, but so too the possibility of tax hikes. For emerging market assets, the upward pressure on US yields will be a key factor and potential hurdle to performance later in the year. For now, emerging markets are benefiting from elevated commodity prices and current account rebalancing. This should support currency valuations, even if dollar depreciation slows. Yet higher commodity prices, notably in agricultural, could limit the ability of monetary policy to remain overly supportive. Many emerging market (EM) central banks have turned more cautious, with markets pricing in hikes for Brazil, Chile, India, and the Philippines. Even in South Africa the market is no longer discounting cuts as the MPC kept the repo rate on hold for a third consecutive meeting.

In SA, there is an incentive for ongoing conservatism

Structural fiscal risk remains a feature of Reserve Bank deliberations, but the government revenue data has been a positive aspect. The economic rebound and strong terms of trade have boosted tax receipts, but this should be seen relative to an overly conservative estimate presented in the supplementary Budget, as well as in the October Medium Term Budget Policy Statement (MTBPS). By many estimates, the overshoot could be as much as R100bn. The question for the pending Budget is whether the Treasury will recognise this fully or whether conservatism will be an ongoing feature. Moreover, this ‘newly discovered’ revenue could lead to renewed demands for grant extensions, while it could also be a complicating factor in the civil service wage negotiations. There seems to be an incentive for ongoing conservatism.

Market developments

Equities off to a solid start

SA equities (5.2%) were off to a solid start in 2021, outperforming the other major local asset classes. Inflation-linked bonds (2.0%) beat fixed-rate bonds (0.7%) amid rallying commodity prices and nascent inflation concerns, while property (-3.2%) underperformed cash (0.3%). The moderate depreciation of the rand (-3.2%) versus the US dollar would have been accretive to offshore and dollar commodity exposure.

The rand lost more than 3% against the dollar

After reaching a three-year low in early January, the dollar index (DXY) posted a modest recovery, aided by taper talk, higher US yields, and periods of risk-off. Even so, currency volatility remained relatively subdued during the month. Treasury Secretary Yellen backed a market-determined exchange rate, which probably lent further support to the greenback. The 0.7% appreciation in the DXY was a headwind to EM currencies, which buckled under renewed risk discrimination and lockdowns. The rand lost 3.2% during the month, keeping company with the Brazilian real and Colombian peso. Nevertheless, USD/ZAR at 15.00 is still modestly overvalued compared to our 15.50 to 16.50 fair-value range.

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Among EM bonds, SA was an outperformer

The Georgian election results, attendant 'Blue Sweep', and taper talk lifted the US 10-year yield to 1.15% amid expectations of large fiscal stimulus and rising funding requirement. Even so, the 10-year TIPS yield remained below -1.0% for most of the month, mitigating some of the headwinds to emerging market bonds. The EMBI lost 1.1% in January, while the GBI-EM declined by 1.5%, despite renewed portfolio flows into EMs. EM credit default swap spreads and bond yields widened during January, but South Africa was a relative outperformer with the 10-year yield unchanged month-on-month. The market remains fairly valued based on our metrics.

Volatility spiked towards month-end

Easy monetary policy, pending fiscal expansion, and the vaccine rollout compensated for lockdowns in January, lending support to already elevated developed equity markets. However, equity volatility as measured by the VIX spiked towards the end of the month as surging retail trading activity triggered short squeezes in selected US stocks. A broader, but temporary risk-off ensued, leaving most major markets down for the month. The MSCI World Index lost 1.0% in January, but the MSCI Emerging Markets Index gained 3.1%, largely thanks to the Chinese market amid ongoing CNY appreciation. Despite the weaker rand, the MSCI South Africa rose by 2.7% in dollar terms, making the market a relative outperformer among EMs. The SWIX gained 5.0% with health care (10.8%) and technology (14.5%) the relative outperformers. Basic materials (5.0%), consumer goods (4.7%), and industrials (4.2%) were broadly in line with the overall performance, while telcos (2.7%), consumer services (2.0%), and financials (-2.6%) were the laggards.

Portfolio performance

Contributors and detractors

The fund's performance (2.0%) in January was driven by domestic equity (1.4% contribution), domestic bonds (0.4%), offshore cash (0.2%), and offshore equity (0.2%). Domestic cash was neutral for performance, while domestic property (-0.3%) detracted. We did not adjust our asset allocation, opting to maintain a neutral equity allocation and a modest overweight duration stance in bonds.

Portfolio positioning

Loss of momentum is expected

Despite serial lockdowns across the US, Europe, and some parts of China, global manufacturing and trade momentum held up reasonably well in January alongside positive surprises in macro data. Even so, some loss of momentum is expected amid an uneven vaccine rollout. Notwithstanding the progress on Biden's stimulus package, markets also reflected a moderating impetus as speculative retail trading and short squeezes led to higher equity market volatility. Beyond this technical distortion, the liquidity backdrop remains supportive of risk assets. Domestically, the adjusted level 3 restrictions dampened mobility in January, but the market impact was more selective than with previous lockdowns. This very likely contributed to the Reserve Bank keeping the repo rate unchanged at the January MPC meeting.

The money market curve steepened

The money market curve steepened anew in January as the rising oil price and modestly weaker rand led the market to price out longer-term policy accommodation. Yet, despite this partial normalisation, inflation-adjusted returns from cash remain inferior relative to other asset classes. Hence, we remain underweight cash in aggregate, and prefer offshore to domestic cash given the overvaluation in the exchange rate, but we acknowledge that the rand could extend gains in a structurally weak dollar environment. Government bonds are fairly valued on our metrics, but the substantial improvement in revenue receipts should be supportive of the market in the near term. Implied real yields of 4% are adequate compensation for fiscal risk, while being accretive to the fund's real return objective.

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Domestic equity is attractively priced

Domestic equity continues to look attractive relative to offshore equity as the strong rebound in earnings compensates for the lower PE valuation on SA Inc counters. While the ongoing pandemic and attendant lockdowns pose downside risk to earnings, it is unlikely that future restrictions will be as severe as those imposed in 2020, as already experienced with the adjusted level 3 lockdown in January. Beyond the beneficial base effects, SA earnings growth should be underpinned by the strong global trade rebound, higher commodity prices, and potential pent-up consumer demand in the shorter term. Developed market equity valuations are elevated, discounting vaccine developments, accommodative monetary policy, and additional fiscal stimulus. Fed tapering and tax hikes are prospective headwinds to returns in 2021.

We have kept high-quality property

Within local equities, we are constructive on SA Inc., but maintain a defensive bias in our stock selection. We have retained a moderate exposure to high-quality property given attractive valuations, but note that the sector could remain under significant pressure due to negative asset revaluations and lower distributions, while the recovery may be prolonged by the ongoing pandemic.

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