Portfolio Manager Quarterly Comment

Market review

'Inflation is like toothpaste', said Dr Karl Otto Pöhl, the late German economist and former President of the Deutsche Bundesbank, 'Once it's out, you can hardly get it back in again'. It is with this in mind that many market participants fear that global central banks, led by the US Federal Reserve (the Fed), may underestimate the risk that the steep rise in consumer prices seen in recent months may not simply be a fleeting phenomenon.

Whether caused by the trillions of dollars worth of stimulus cash still present in the global economy, or the relentless rise in commodity prices, or by supply blockages that have constrained the production (and pushed up the prices) of a range of key products, or whether it's simply just 'base effects' given the collapse in prices in the first half of last year, the second quarter of 2021 was the time in which inflation finally came to bear, particularly in the US (where May CPI reached 5%). Not only has US inflation risen sharply, but CPI prints exceeded consensus forecasts in each of the three months for which CPI was released in the quarter quite comfortably. Despite this, the Fed seems to have gained the upper hand in the tug of war it has been waging with the bond market regarding whether hikes in US policy rates will have to happen sooner and be steeper, with the 10-year Treasury bond yield declining to 1.47% by quarter-end from 1.74% at the end of March, and with the US yield curve flattening considerably over the period too.

The more benevolent yield environment helped to support global risk assets, with the MSCI World Index returning 7.7% in the quarter, and the MSCI Emerging Markets (EM) Index returning 5.1%. Commodity prices continued to soar, with the Bloomberg Commodity Index ending the quarter 13.3% higher.

The Covid-19 pandemic is far from over, with much of Asia, Latin America and Africa experiencing their highest level of new cases of the entire pandemic in the second quarter of 2021 (Q2). However, increased resilience of the global economy to the effects of the pandemic, together with aggressive vaccination efforts in key developed markets allowing reduced restrictions, saw global economic growth continue to impress in the quarter. The JPMorgan Global Composite Purchasing Managers' Index (PMI) number for May, at 58.0, was the highest on record, with a big rebound in the services index (59.4) combining with a continued strength in the manufacturing index (55.5).

The local economy has also surprised many in its capacity to rise quite remarkably from the ashes of 2020's harsh Covid-19 lockdowns. While the consensus view was that the first-quarter (Q1) GDP growth number would be an encouraging one (with a mean forecast of 3.2%), the actual print of 4.6% was appreciably higher than expected. A major part of this surprise in growth was not of our doing, however, as the country benefited from the steep rise in commodity prices that boosted terms of trade and pushed the trade balance to record levels. This resulted in a welcome windfall for the country's tax coffers, with National Treasury announcing early in May a R900 million reduction in its weekly nominal bond auction amount from R4.8 billion to R3.9 billion. Higher levels of inflation, with May CPI reaching 5.2%, were shrugged off by the South African Reserve Bank (SARB), which kept its repo rate unchanged through the quarter.

Domestic equities had a disappointing quarter, especially in the context of firmer global stocks, as the FTSE/JSE Shareholder Weighted All Share Index (SWIX) declined 1.8% on a total return basis. Listed property stocks ignored the weakness in the broader market, gaining 12.1%. Nominal bonds benefited from lower global yields, and reduced auction amounts, as the FTSE/JSE All Bond Index (ALBI) returned 6.9% (with most of the gains coming from the flattening of the yield curve). Inflation-linked bonds (ILBs) lagged nominal bonds, but the FTSE/JSE Composite Inflation-Linked Index (CILI) still returned a respectable 3% in the quarter, while cash returned 0.9%.

In US dollar terms, the MSCI World Index advanced 7.7% in the quarter, the fifth consecutive quarter of gains in global stocks. Emerging market equities held their own, with the MSCI EM Index returning 5%. Global bonds, as represented by the Bloomberg Barclays Global Aggregate Bond Index, returned 1.3% on the back of lower US yields. Despite some weakness experienced in the month of June, the rand rose 3.3% against the US dollar to end the quarter at 14.28.

Asset allocation

We continued to increase global effective equity exposure in Q2 into a positive risk-on environment, as markets remain well supported by the combination of significant global liquidity and record-low interest rates. It appears the global spike in inflation is transitory and developed market central banks have been vindicated by standing pat on hiking rates. These stances have continued to support the rise in global equities in Q2. Our effective local equity position ended the quarter marginally higher, given the 20%+ discount that the market trades at relative to our in-house fundamental, bottom-up valuation of the asset class.

Local nominal bonds were increased at the expense of SA cash (short-term interest-bearing (STIB) assets) while we have slowed down our purchases of local inflation-linked bonds due to the value in their real yields appearing full and the temporary spike in SA inflation potentially having passed.

Local listed property continues to deliver a solid recovery in market performance but on a forward dividend yield versus nominal bonds basis, is still expensive, let alone the high levels of volatility it introduces into the funds. We believe the property sector to be fundamentally weak with some structural headwinds still to overcome. On a relative basis, we find equities to be more attractive than property stocks.

On the broader offshore allocation of the fund, in spite of the strengthening local currency having dampened our returns of late, we remain of the view that the investment merit for retaining a fair exposure to foreign assets in the fund remains intact due to the natural hedge and diversification benefits it provides. Further, the rand is trading at purchasing power parity to the US dollar warranting more of a neutral position as opposed to underweighting foreign assets. Within foreign assets, on a relative valuation basis, equities are preferred over other asset classes. Our exposure to foreign bonds is mainly through investments held in the dollar-denominated issuances of SA corporates priced at attractive spreads over US Treasuries. We do not hold developed market sovereign debt instruments due to the unappealing negative real yields on offer. Global property is on our radar given the ability to gain exposure to good quality stocks in structurally sound niche property sectors.

In summary, we have been slowing down our position building in ILBs given that SA inflation prints are expected to be peaking and deflationary forces dominating again. In SA nominal bonds we continue to build exposure given attractive relative valuations and they provide good income relative to cash and inflation. We prefer government bonds over credit. We remain buyers of SA equity at the expense of SA cash/STIB instruments and we retain our foreign exposure with a preference for equities over bonds over cash.

Looking ahead, we maintain our pragmatic value asset allocation stance, focusing on providing good quality returns, backed by sound fundamental research, while continuing to protect capital in an environment where market volatility is expected to remain elevated, and macro and geopolitical uncertainty, greed and fear remain the order of the day. We continue to follow a tactical approach in managing the fund, ensuring that we invest in assets that present attractive relative return opportunities on the one hand, while managing drawdown risk on the other.

Short-term interest-bearing instruments

Q2 saw a greater range of borrowers accessing the debt capital markets, enticed by still-low Jibar rates, as well as investor demand that has helped push credit spreads lower. This is in contrast to credit markets that were in limbo for large parts of 2020.

Bank issuers dominated the auctions seen in April, with Nedbank (R2.2 billion in 5- and 7-year notes) and Investec (R1.4 billion in 3- and 5-year notes) raising senior debt, while FirstRand Bank raised over R3 billion in 10 non-call 5-year subordinated debt, the fixed-rate notes of which we found attractive enough to participate in. Even African Bank borrowed R220 million in 3-year senior notes. Corporate issuance included deals by Growthpoint (R249 million in 3- and 5-year notes), Investec Property Fund (R800 million in 3-year notes), KAP Industrial (R525 million in 3-year notes), and Northam Platinum tapping its existing 1-year maturity notes for an additional R1.9 billion. Amber House was the sole securitisation borrower, raising R1.2 billion, while SANRAL was the only state-owned enterprise (SOE) in the market as it also raised R1.2 billion.

Corporates were responsible for the bulk of issuance in April, headlined by Pepkor Holdings' R2.2 billion issue of 3- and 5-year notes. The other prominent borrower was Mercedes Benz, which raised R1 billion in 3-year notes, while Emira Property Fund (R380 million) and Resilient Property Fund (R615 million) both raised 3-year funding. Northam Platinum also tapped a range of its 1- and 2-year notes to the extent of R450 million. Investec Bank issued R3.1 billion in 3- and 5-year senior notes, while Investec Limited raised R600 million in 5-year subordinated debt. Transsec 5 was the major securitisation borrower, as it raised R900 million, although Redlink Rental also issued R83 million of notes. SOEs were quiet again, with only Transnet raising small amounts through tap issues.

June saw significant issuance by banks, with FirstRand Bank raising R3 billion in senior notes of maturities ranging from 3 to 10 years and Standard Bank Group raising R1.7 billion in 10 non-call 5-year subordinated notes. Demand for MTN Holdings paper was strong, as the company raised R2.3 billion in 1-, 3-, 5- and 7-year notes which all cleared inside the auction guidance. A rare SOE borrower in the month was Rand Water, which also saw significant demand for its R1.7 billion of notes with maturities of between 5 and 15 years.

The money markets continued to be a tough environment to be invested in as the market continues to price in repo rate hikes from late 2021, and CPI releases show the extent to which higher inflation has materialised. Although bank floating-rate note spreads remained fairly flat in the quarter, higher swap rates meant that the bank fixed negotiable certificate of deposit (NCD) curve moved higher, although it was also flatter, with 3-year NCD yields rising 0.23% to 6.07% and 5-year NCD yields rising 0.06% to 7.14%. The Jibar rate barely moved though, ending the quarter 0.017% higher at 3.692%.

We have continued to reduce the fund's allocation to floating-rate credit and money market instruments (STIB instruments), in favour of a greater allocation to nominal, and to a lesser extent, inflation-linked bonds. In an environment of the Jibar rate being well below current levels of inflation, floating-rate bank and corporate credit has become especially unattractive when compared to government bonds or instruments that price off the government curve. The transition out of STIB instruments has not been undertaken overly aggressively, as we continue to get respectable real yields from holdings of STIB instruments. Rather, we have looked for moments of bond market weakness to increase our holdings of them, especially if this coincides with significant maturities in STIB instruments.

Equities

The market declined slightly after an exceptionally strong Q1, with the SWIX down 1.8% in Q2. The resources sector declined by 5% in Q2 as a result of a fall in industrial and precious metal commodity prices after an extended period of previously rising prices. Some cooling off of global economic growth towards the end of the quarter was no doubt a contributing factor, particularly with demand out of China slowing. Industrials moved sideways, with the sector up 0.8%, although there was a wide dispersion of returns within the sector, with the personal goods and support services sectors performing strongly, while the technology sector was down sharply.

Financials performed the strongest in Q2, with bank shares performing particularly well, aiding a sector performance of 7.5% for Q2. Year-to-date the SWIX is up 11.2%, with all three sectors performing broadly similarly, with industrials leading, up 13.8%, followed by the resources sector, up 12.8%, and financials up a respectful 11.7%. The best performing areas of the market year-to-date have been the more economically-sensitive local shares and the chemical sector, given the rapid rise in the oil price. The weakest sector has been the technology sector given the regulatory and other challenges they have faced.

The SIM equity house view portfolio performed broadly in line with the benchmark for Q2, after an exceptionally strong relative performance in Q1. The second quarter was characterised by stock picking as performance was shaped by individual stocks rather than any particular sector weighting, although our underweight position in financials did cost us some performance. The weakness in the resources sector in Q2 was offset by our relative positions performing better than the sector. We have continued to reposition within the resources sector. Selective industrial counters also contributed as the local economy surprised in its resilience during the quarter.

The resources sector declined slightly in Q2, with our overweight platinum positions detracting from performance, although we have no exposure to Anglo American Platinum, which declined the most among the platinum stocks. Over time we have reduced our exposure to the sector, although with the decline in the quarter we were able to up-weight Northam Platinum where we remain more constructive. The gold shares were also weak in Q2 and our underweight position contributed to performance. Our large overweight position in Sasol contributed positively as the oil price was one of the few commodity prices that actually rose in Q2. Our view on Sasol is not premised on a higher oil price, although this was welcome. On the other hand, Sappi, which had run up strongly in Q1, reversed somewhat in Q2, detracting from performance. The large mining houses performed broadly in line with the market and were not major differentiators in Q2.

Within the industrial sector there was a fair amount of price divergence, and performance was more about stock picking in Q2. The technology sector globally is facing more challenges, with regulatory concerns weighing on Naspers' associate Tencent. The announcement by Prosus of a voluntary offer to swap shares in Naspers for Prosus has not been received well by the market and contributed to Naspers's underperformance in the period, notwithstanding strong earnings growth in its latest results. We are overweight the group, which detracted from active performance. On the other hand, there were strong contributors from our overweight positions in Distell, which is the subject of corporate action, Dis-Chem, which is past a period of growth indigestion and performed well post results, as well as MTN, which continues to deliver on its strategic objectives and surprised positively in its latest results.

Financials performed well in Q2. It was again about stock picking with our overweight position in Nedbank contributing positively, while our underweight position in Discovery also added alpha. Our underweight position in Capitec detracted as the share performed very well in the quarter and is now at levels prior to the pandemic. The insurance counters moved broadly in line with the market, neither adding to nor detracting from performance.

SIM equity strategy

We remain mindful that we continue to have an overweight position in the resources sector as a confluence of factors has arisen to support the sector for longer than initially expected. While a number of commodity prices are now well above our long-term forecasts, within the sector there are other commodity prices that remain below our long-term 'normalised pricing'. With this in mind, sector and stock selection within the mining sector are now more important. We have been rotating out of areas that have done well and recycling back into different areas that are currently weak or out of favour. That said, we are also pragmatic and recognise that a more nuanced approach is required as in some instances pricing has remained reasonable while capacity limitations in certain commodities will result in pricing remaining relatively buoyant for an extended period. As always, the near-term strong outlook needs to be tempered with a healthy sense check and a significant margin of safety from a valuation perspective.

On the financial side of the portfolio, there has been a sharp rebound as better-than-expected results and a gradually improving economy have surprised market participants. As to how much of this earnings surprise continues remains to be seen, although in many instances the full recovery has not been priced in as some uncertainty remains. We have trimmed selective financial counters, although mainly in the insurance sector as we believe there is better value elsewhere.

We have made selective additions to industrial counters that look well placed for a gradually improving local economy but have been held back by investor caution or uncertainty as to when the economy will recover fully.

Equity outlook

We prefer stock picking and do not want to rely unduly on the SA economy performing as it is unclear post the Covid-19 recovery whether we shift into an environment of more meaningful economic growth. We prefer to seek opportunities where expectations are cautious and a heathy margin of safety exists from a valuation perspective. A number of international counters are also looking more interesting after a bout of weakness and rand strength, and we've been adding to those counters which currently seem very out of favour.

The environment over the past 18 months has resulted in significant disruptions making detailed stock picking work worthwhile and, as always, we will endeavour to seek the best opportunities for the fund using our pragmatic value detail-orientated bottom-up research process. A long-term though-the-cycle orientation is key, as is the ability to weather the storm in anticipation of future returns.

Bonds

If Q1 was characterised by a dramatic sell-off in US Treasuries, Q2 was characterised by the weakness of the US dollar, at least until the Federal Open Market Committee (FOMC) meeting. The US Dollar Index briefly traded below 90, a support level it has sustained over the last three years, before bouncing back to end the quarter at 92.4, just 0.85% lower. The benchmark 10-year US Treasury traded firmer from 1.74% to 1.47%. The pullback in yields was surprising, given the continued upward surprises in the rate of consumer inflation and upward revisions to growth.

The Bloomberg Barclays EM Local Currency Government Diversified Index staged a recovery to gain 2.9% during the quarter compared to a loss of 6.5% in the first quarter. The ALBI returned 6.9% as the yield curve flattened, resulting in outperformance by long-dated bonds. The 12+ year sector of the index returned 10.1%. The market was supported by a generally stronger currency and a reduction in weekly issuance by National Treasury, which reduced weekly nominal bond issuance from R4.8 billion to R3.9 billion. There is an expectation that National Treasury will introduce a floating-rate bond later this year and also a local currency sukuk (a bond that is compliant with Islamic principles). Should these plans come to fruition the issuance of fixed-rate nominal bonds could be reduced further.

After a very strong Q1, ILBs underperformed nominal bonds but still delivered 3%, well ahead of cash returns. Demand for ILBs has waned, with the last two auctions in June being under-allotted. With inflation having peaked in May, the inflation accruals on these bonds will be significantly lower after July.

In the quarter we continued to add to the fund’s nominal bond allocation, as well as to extend duration, while reducing the overweight position in cash and STIBs. This is in response to the relatively lower yields provided by cash and STIBs in the current low-rate environment, compared to nominal bonds that offer much more appealing real returns. Our preferred bond was the R2032, which we picked up in periods of market weakness, although we did add to the fund’s R186 and R2030 allocations on occasion. We also invested in the fixed-rate tranche of FirstRand Bank’s subordinated bond instrument issued in April, and benchmarked off the R186. The fund’s relatively low-duration position when compared to the ALBI meant that its bond allocation underperformed the index in a quarter characterised by considerable yield curve flattening. We, however, remain satisfied with our overweight position in ‘belly, bonds, which we feel provide excellent yields without the greater duration risk found further out in the curve. We also maintain our preference for nominal bonds in general over ILBs, which, despite an excellent start to the year, should see some weakness over the rest of 2021.

International

Q2 has seen a resurgence in positive global coronavirus cases; the new Delta variant is a major risk to global growth prospects. The quarter ended in June with a wide dispersion in new cases, with these levelling off in the US but increasing in countries including India, the UK, Australia and South Africa. These resurgences have resulted in record death rates, notably India, and prompted governments around the world to impose renewed population movement restrictions in a bid to once again slow the spread of the virus. On the positive side, however, global vaccinations against Covid-19 have been progressing very well, and there is evidence that current vaccines are effective against the new Delta strain, which is vitally important in reducing the number of infections which ultimately lead to hospitalisations. Consequently, despite the increases in the number of new cases globally, countries where vaccinations have been progressing well have seen a reduction in severe illness and hospitalisations, with the latter being the main consideration for governments vis-à-vis imposition of renewed lockdowns.

The quarter also saw significant gains in global economic growth spurred by the developed economies, in particular the US, which is expected to surpass its pre-crisis level. The European Union (EU) experienced a technical recession but is expected to bounce back as vaccinations there start to pick up pace. Overall, the huge global stimulus led by the US, as well as significant pent-up demand, should see a continued global economic recovery in Q2.

Evidence of inflation rising globally and becoming more broad-based is now more accepted, accentuated by supply disruptions and capacity constraints, as well as manufacturing and transportation bottlenecks. For now, it appears as if rising inflation may be temporary, induced by the disruptions from Covid-19 and not a function of unreasonable demand. Earlier in the year, US bond yields had risen in expectation of higher inflation and robust economic growth, however, in Q2, long-term yields declined as most investors expect the recent bout of inflation now to be temporary. The Fed has indicated that it will tolerate inflation above its long-term expectations of around 2% for an extended period, as ultimately, they expect inflation to revert downwards after this initial spike. There is a risk that the Fed may be behind the curve, as inflation expectations continue to ratchet up in response to various input costs that continue to rise and a lack of investment in new capacity, which has supported higher prices for longer. Current demand is distorted by an extended period of lockdown in some key segments and consumer confidence that has been stimulated by central bank liquidity. Inevitably something will have to give as debt levels in the US, Europe, Japan and elsewhere look very elevated and are likely to crowd out investment unless incremental capital can be efficiently deployed.

Emerging markets have lagged developed markets as they have not had the benefit of near-zero interest rates nor the central bank support that the developed markets have enjoyed. Shifts to more environmentally-friendly energy sources have already started to create supply challenges in some key markets. This will need to be monitored carefully, especially as energy producers have been very reluctant to bring on new capacity in environmentally-challenged sectors. China as an example experienced some manufacturing disruptions in Q2 due to energy challenges, which may be made far worse in future if the country is to achieve its recently profiled and ambitious environmental aspirations. In relation to global market performances, it was another risk-on quarter with the MSCI World Index returning 7.7% and the MSCI EM Index 5.1%. Developed markets have performed well, aided by record low interest rates, significant government support and a strongly recovering market, with the impact from the virus receding. Emerging markets have not enjoyed the same level of support, although rising commodity prices have aided selected markets. Global bonds, as measured by the Bloomberg Barclays Global Aggregate Bond Index, increased by 1.3%. The US Dollar Index was slightly weaker by 0.9% and the rand strengthened by 3.3% to end the quarter at 14.28 to the US dollar.

Investments

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