Portfolio Manager Quarterly Comment

Market review

In the first quarter of 2021 (1Q21) the US economy continued to make strides towards its recovery, aided by a successful general election, notwithstanding inauguration disruptions from Trump supporters in Washington. Biden and the Democratic Party took control of both the House and the Senate, enabling changes to be implemented decisively. Much like other countries, the US nevertheless is still struggling to deal with the impact of Covid-19 as well as to ensure the speedy rollout of vaccines to the electorate. However, Biden has moved quickly to roll out vaccines in order to open up markets as the aftermath of the pandemic has dramatically impacted the large service sector of the US economy.

Improving confidence and declining infection rates, aided by national vaccine rollouts, are viewed as key to a sustainable improvement in the service sector. Mutating variants of the virus are nevertheless keeping people cautious and it will take considerable time for some sectors of the economy to recover completely, if at all. There is no doubt that some capacity has permanently exited the market, as not all businesses were able to fund the duration of lockdown and restrictions. It has been over a year since restrictions were initially implemented. The full impact from the virus remains unclear at this stage, while the US government continues to support voters with federal government support in the form of monthly stimulus cheques. US job hires are being distorted by many people staying at home and rather opting to receive government assistance.

Suppressed consumption is boosting savings but this is unlikely to assist GDP. Biden, with federal support, is now looking to further boost the US economy with over $4 trillion of support potentially available. Some of this will be funded by a proposed increase in the US corporate tax rate. While a significant part of these funds has been earmarked for infrastructure projects, the effectiveness of all this future spending on the overall economy remains unclear. Biden also has to ensure that these plans are passed by government, which at this stage is not a certainty. In addition, the US government is now experiencing debt levels well above normal and is at the point where incremental spending tends to be less and less effective.

There is also the risk of crowding out in the economy as rising debt limits the ability to reignite GDP without a significant improvement in consumer confidence. To date, there remains a fair amount of unevenness to the recovery, with the manufacturing sector recovering well, while the service economy looks to be taking longer. Consumers are increasingly becoming more disgruntled having been constrained in lockdown for an extended period; this is manifesting itself in increased social unrest. A successful vaccine rollout may alleviate some of this tension, although the widening income inequality will need to be watched. At some point the generous government support measures will need to be reduced and then the real impact of Covid-19 on the economy can be properly assessed.

At this stage it is likely that unemployment will rise once funding support is reduced and remain at a higher level notwithstanding the current numbers showing an improvement. Some structural changes are also inevitable as workers have become more comfortable working from home. Commercial property inevitably looks like the loser. Signs are also emerging of rising inflation, with agricultural and commodity prices elevated. Supply chains are also being severely disrupted, as evidenced by the severe global electronic chip shortage. These supply chain disruptions are necessitating rising global stock levels as well as more costly local manufacturing. This theme, which started under Trump, is now becoming a global issue. Countries are looking to become more self-reliant, support local industries, penalise importers and shift supply chains inward. The past globalisation agenda seems to be taking a back seat for now.

Environmental concerns are also creating inflationary pressures as traditional energy markets are not getting adequate capital for expansion over the medium term. This lack of investment may create some pricing distortions in the energy supply chain in the not too distant future. The shift to electrical and fuel cell vehicles is also going to create some distortions in the car manufacturing industry that will need to be navigated. At this stage we expect a strong rebound in economic growth in 2021, although this is off the weak 2020 base and somewhat distorted by government funding. We remain of the view that it will take a while before the US economy recovers completely, while several risks remain that post the initial recovery, that US economic growth in 2022 may be more muted than initially anticipated.

In Europe, the economic recovery has been more modest as vaccine rollouts have been slower due to political friction within the European Union (EU). By contrast, the UK, which recently exited the EU, has been able to vaccinate a large part of their population relatively quickly. The UK experienced rising infection levels of the virus earlier and needed to take more decisive action, which it did by increasing lockdown restrictions. These hard lockdowns have had a marked negative impact on their economic recovery as growth here has lagged their EU neighbours. It was always going to be difficult to enact policy across the EU with regard to both vaccine access and rollout – this has slowed Europe's vaccine availability. Developed economies with greater access to funding have secured more upfront vaccine certainty, and developing economies look to be disadvantaged. The slow vaccine rollout in Europe may be a contributing factor to recent rising infection levels in some European markets, with France experiencing notable increases and having to re-enact strict lockdown measures.

Europe's economic recovery is likely to remain slow, but noting that Europe was only showing modest growth prior to the arrival of the virus, so this is not a complete surprise. The European Central Bank (ECB) continues to provide funding and has accelerated their bond buying programme in March, with a view to keeping rising interest rates in check. Inflation within the EU has risen recently, although largely due to exogenous factors like a recovering oil price. Underlying demand remains muted within the EU, although technically, like with the US, we expect to see a robust recovery to GDP through 2021, largely due to the weak base in the prior year. Government consumer support measures across the EU are also creating an artificial recovery. The sustainability of the recovery will only be able to be properly assessed post the withdrawal of these stimulus measures. Rising debt levels in Europe will also create future challenges, notwithstanding record low funding rates. Europe has also been hard hit by weakness in the service sector, particularly areas like tourism and entertainment, although other areas like manufacturing have rebounded somewhat. Rising environmental demands by the EU are also likely to be inflationary and will need to be carefully managed over the medium term.

Emerging markets (EM) have not had the luxury of large government support measures and so their recoveries have been somewhat patchy. These recoveries are probably more indicative of the true recovery of their economies relative to developed markets, which have been partially propped up by fiscal support. Interest rates in EM are also higher and until recently were declining. However, they remain significantly above developed market peers. This has constrained any recovery and has created funding challenges. Recently some EM have in fact started raising interest rates as inflation started to rise and also with a view to attracting foreign capital. As with developed markets, lower interest rates in isolation are not sufficient. What is required is consumer confidence, good policy intervention and management from a government perspective, which all play an important role. Vaccine challenges in EM have resulted in low levels of inoculation, creating economic recovery challenges for many emerging economies. Low vaccine rollouts coupled with poor government response have also resulted in rising infection levels. Markets like Brazil are seeing a rapid rise in infection levels, creating hospitalisation challenges and weakening future electoral support for incumbent politicians.

China's recovery has, however, been remarkable and in some instances is performing well ahead of expectations, with the housing market requiring some policy intervention to curb demand. China is benefiting from a command economy and being able to be more decisive with regard to the movement of people, but is also benefiting from rapid technological adoption. The broader Asian region has performed fairly well, although Japan appears to be struggling with weak growth and demographic challenges. India has also been performing well, although there are signs of rising infection levels.

The quarter was characterised by rising inflation in certain markets, aided by strong commodity and agricultural prices, which would have benefited certain EM producers and exporters. However, supply challenges are nevertheless making market access more difficult. Mining and energy companies have also been cautious, particularly with regard to deploying surplus capital after being caught investing at the peak of the past resource cycle. This lack of investment means that capacity increases across the commodity complex are likely to be slower, potentially supporting rising prices for a more extended period than would ordinarily be the case. The oil price also rose sharply in the quarter, aiding oil producers. A buoyant fourth quarter of 2020 (4Q20) for commodity producers and EM countries more broadly, as well as extended liquidity in developed markets, has resulted in improved funding for EM in 2021 – although there is now growing caution in the second quarter of 2021 as virus infection rates appear to be increasing again in some regions. EM governments seem to be more inward-focused and political issues remain.

Supply chain issues globally are creating bottlenecks and increasing the need for local supply, which may compromise the traditional EM producers and increase inflation globally. Politically, China continues to exert its influence regionally and markets now await to see how open Biden's policies will be relative to Trump's, who wanted to be more aggressive internationally and strengthen US economic interests without playing a broader international geopolitical role. China looks set to play a more expansive role internationally. Ongoing trade challenges seem inevitable, with EM caught in the crossfire. We expect EM recovery to be supported by global liquidity, rising inflation expectations and a supportive background for commodities, although within the peer group there are likely to be diverging performances.

In South Africa, the economy continues to recover slowly and is being held back by the measured reopening of the economy. Rising infection rates in December and subsequent increased lockdown measures in the new year did not assist confidence. Like many other markets, SA has over time become more of a service-based economy, which is an area that has been more negatively impacted by the virus. Towards the end of 1Q21, with infection rates dropping, restrictions were eased. Notwithstanding a proactive approach to managing the virus, there is broad dissatisfaction with the rollout of vaccines in SA, with a major initial batch received by AstraZeneca deemed ineffective against the local variant and was not used. Securing a sufficient supply of vaccines remains challenging, although progress is expected by mid-year. In the meantime SA faces the risk of a third wave as the country enters winter.
Business is likely to remain cautious until vaccine progress is sufficiently developed. Business confidence declined through the quarter and especially in manufacturing, mining and electricity generation, with ongoing electricity disruptions not doing much for consumer confidence. Notwithstanding weak business confidence, consumer confidence improved slightly, although admittedly off a weak base. Inflation has been rising, but overall remains well contained given the weak economy. Interest rates look to remain on hold for an extended period. Over time it is hoped that the low interest rates will stimulate some recovery in the economy, although admittedly improved business and consumer confidence is critical.

The SA government has not been particularly supportive to small and medium-sized enterprises and these remain the most vulnerable. Significant capacity in this area has permanently left the market, given the fact that access to capital is limited and the impact from Covid-19-induced lockdowns has now been felt for an extended period of time. Larger enterprises have been able to reduce capacity, cut costs, draw on long-term funding facilities, and have generally managed better. Government income support to the most vulnerable has provided some income relief, although the amounts remain modest and are at risk of being withdrawn over time. The South African Reserve Bank (SARB) governor produced a credible budget in 1Q21, although there was not much in the way of decisive new government policies. Funding remains a challenge and is likely to remain so for an extended period of time, notwithstanding slightly improved tax collection figures in 4Q20 and early in 2021 relative to expectations. The economy remains narrowly funded and requires a broader participation economically.

In 1Q21, there has been a rise in agricultural prices and the good crop outlook means that there is some confidence here. In addition, mining commodity prices continued to rise and with the economy opening up, strong export figures were evident from several commodity producers at the start of 2021. The trade figures also reaped the benefit of a buoyant export market, with SA recording a large trade surplus in 1Q21, which should support the rand. Political inertia and ongoing issues, plus a lack of policy intervention and weak economies adjacent to SA, are delaying a more decisive economic recovery. The SA economy is expected to recover in 2021, although the pace of growth will be modest and SA still faces many structural challenges, including the outsized share that government has of the economy. Also, the infighting between labour unions and SA government as government looks to manage costs in order to curtail ballooning government debt is not helpful. Many state-owned entities and local municipalities are facing structural and financial challenges, which require intervention and/or capital injections. We expect a gradual local economic recovery, aided by vaccine availability, with consumer confidence improving over time, although lingering challenges are likely to remain.

From a financial market perspective, equity markets had a positive performance in 1Q21 aided by significant fiscal support in developed markets and a strong rebound economically, albeit off a weak base post initial Covid-19 lockdowns. A successful US election has also aided market confidence, as did the rapid rise in vaccine availability in the US and the UK. Vaccine availability has, however, been unevenly distributed globally, with economies that have had access generally performing better. Rising infection levels in Europe have injected some caution into some of these markets.

The large amount of money made available by governments, particularly the US and EU, is fuelling rising global inflation, although at this stage it is still not a major cause for concern. Long-term bond yields rose significantly during the first quarter on expectations that markets would recover more decisively post the rollout of vaccines and given that we started seeing signs of rising prices in commodities and more broadly. Supply bottlenecks and capacity issues are also helping to fuel inflation concerns. During 4Q20 the US dollar was weak, but in 1Q21 it remained stable as some consolidation was evident. Rising long-term rates in the US will no doubt attract some capital.

Emerging market currencies broadly consolidated gains from 4Q20 as markets wait to see how broad-based the global economic recovery will be. Some markets look likely to experience modest economic growth post the Covid-19 bounce. Governments globally are looking to play a broader role in their economies, whether it is the US, Europe or Japan, while China has already been doing so for an extended period. History has shown that overzealous government intervention can stifle innovation and weaken economic growth if not done in a sensible way. No doubt some industries, notably tech, have become too influential over time and some form of government intervention is inevitable. During the quarter we saw increased intervention by the Chinese government in their tech sector as it looks to manage the social barometer.

From a source of supply perspective, disruptions in the global supply chain are creating bottlenecks and increasing prices. Commodity prices rose further in the quarter, with the oil price increasing further as OPEC constrained output. The one commodity that did not rise noticeably in the quarter was the gold price, which in fact dropped by over US$200 per ounce as improving economies reversed the risk-off trade. This may be somewhat structural as crypto currencies are playing a more functional role in global liquidity, although the crypto market still remains relatively small and yet to prove its store of value credentials through a complete interest rate cycle.

From an SA perspective, the continued rise in commodity prices globally assisted our equity market, specifically the resources sector. The rollout of vaccines globally also assisted our market and especially shares which have more international exposure. For 1Q21 the FTSE/JSE Shareholder Weighted All Share Index (SWIX) was up 13.3% with the resources sector up strongly, by 18.7%, with a strong contribution from the chemicals and industrial metals sub-sectors. The industrial sector also performed well, aided by a strong contribution from the telecoms sector and a number of economically-sensitive local sub-sectors, like electronics, transportation and support services. Some of the more defensive industrial sectors lagged the market as cyclicals took centre stage.

The financial sector lagged the SWIX, producing a modest 3.3% performance for 1Q21, with both the banks and insurance sectors lagging. Financials are proving more directly exposed to the SA macro and with Covid-19 provisions hitting the insurance counters and weak credit growth within the banks, a full recovery here will take time. The property sector recovered after being very weak in 2020 but still lagged the overall performance of the market.

Fund performance

The SIM Top Choice Fund added 4.9% alpha in the first quarter of 2021, ahead of the SWIX's 13.3% return. The fund posted a 70.9% return for the year ended March 2021, following an impressive absolute and relative performance outcome versus the SWIX's 51.5% during Covid-19, which could be described as the worst pandemic in the last century. Many of the same stocks that performed poorly in the first half of last year drove the outperformance in the second. Almost every company in the portfolio was positive in 1Q21 with almost half producing double-digit returns.

Our overweight position in Sasol was the largest single relative and absolute contributor. Sasol, like almost all energy stocks in the rest of the world, was by far the worst performing share in 2020. Sasol is on track to turn the corner both operationally and financially after two very challenging years. At last reported results, management highlighted that a decision was made not to pursue a rights issue given the current macroeconomic outlook and the significant progress made on their response plan initiatives. Management reiterated that the balance sheet deleveraging pathway will continue to be prioritised to ensure that they operate within their financial covenants and maintain adequate liquidity headroom, while delivering the Sasol 2.0 transformation programme. We have a pragmatic investment approach to Sasol, recognising there is significant upside to our intrinsic value, but also that there are significant risks outside of the company's control.

Our valuation allows for a discount due to the carbon and emission intensity of Sasol's South African value chain and the risks to the investment case arising from the transition to a low carbon/emissions future (capex burden, gas availability/cost, risk of increased carbon tax) and resulting impact on asset lives.

Sappi was a top contributor and an overweight position for 1Q21. In our view, Sappi is well positioned to benefit from a sustainable product offering, recovering DWP prices and volume/mix improvement in speciality packaging.

Dissolving wood pulp (DWP), a key driver of Sappi's earnings, was well below what we determined as a sustainable 'through-the-cycle' level and this resulted in severe near-term earnings pressure. This and a stretched balance sheet, due to an ill-timed acquisition of a US-based pulp mill, resulted in Sappi trading at a deep discount to what we determined to be the true intrinsic value for the company. By way of detailed analysis, we were able to build enough conviction to add a meaningful portfolio position at what we deemed was a very attractive level.

The DWP price is up US$500/t since the start of October 2020 – driven by recovering viscose demand and limited DWP supply due to the low price premium versus paper pulp. This DWP price recovery, while sooner than we might have anticipated, materially improves the outlook for Sappi's earnings and balance sheet and has resulted in a sharp rise in the Sappi share price from the 2020 lows. This has been particularly satisfying as it reinforces our approach of detailed bottom-up analysis, and being willing to back yourself when the numbers stack up, despite consensus advocating an investment decision in the opposite direction.

As mentioned above, in our view, Sappi is not only a 'cyclical recovery' play. The business is in transformation. Sappi is moving towards more stable 'speciality' grades, which have longer-term contracts and are exposed to more stable consumer-oriented end demand. This should increase price/volume predictability.

Impala was also a top contributor for the quarter. Impala like many of its PGM peers continues to generate significant free cash flow for shareholders while current strong PGM basket price conditions persist. With no major expansion projects on the horizon, cash returns to shareholders should be a priority over the coming year. Despite the positive near-term outlook, we continued to use the strength in the Impala share price during the quarter to further reduce the significant portfolio overweight position as the upside from the share price to our estimate of fair value narrows further.

Almost all the banking (ABSA, FirstRand, Standard Bank) and insurance (Old Mutual) stocks detracted from performance over the quarter. South African banks all reported financial results in the past quarter which were not unexpectedly materially weak relative to history. These results were characterised by a backdrop described as 'the worst pandemic on record in 100 years' by many of the bank management teams due to the Covid-19 virus. Importantly, our thesis remained intact that this has largely been a pandemic-induced credit loss-impacted cycle, with some pressure seen in transactional income predominantly in the retail banking space, as the economy remained in a tepid and vulnerable state. It became evident with the last round of results that credit losses peaked in June 2020 and are now on an incrementally improving trajectory, with all the banks experiencing some degree of resilience within their various client franchises. We hold the view that the banking shares offer value on a through-the-cycle basis and while we do not expect a sudden rerating back to that value, we are patient to wait for the realisation of this value through time, as the banking industry slowly recovers from this extremely challenging period.

Old Mutual posted poor 2020 year-end results on the back of excess deaths due to Covid-19. The Mass Foundation business aimed at the entry level or lower end of the market where the company commands well over 50% market share, was hit hard as agents were unable to conduct face-to-face business with clients. As a result, sales and margins collapsed. The Affluent life business held up relatively well while the short-term insurance business continues to record low underwriting margins compared with the peer group. There is still an outstanding R2 billion buffer to cover excess deaths in 2021, but prospects for operating earnings remain unclear. Management believes the business will revert to normal conditions by 2023. The company has a strong balance sheet with a solvency ratio of 185% above regulatory capital. In addition, the company continues to generate cost savings of approximately R800 million per annum, including an option to repatriate some £25 million cash left in the residual PLC entity. We believe management has scope to explore a share buyback programme as conditions normalise given the share price offers compelling value on both sum-of-the-parts valuation and earnings multiples.

Portfolio activity

While the research team has been busy poring over multiple new ideas this year, the buy list of qualifying investments shrunk as stock prices rallied across the board. Our only addition in the first quarter was a small position in Standard Bank funded from the active trimming of several strong performers such as Sasol, Sibanye-Stillwater and Anglo American. The portfolio remained fully invested in about 20 shares.

Outlook

While the Covid-19-influenced volatility of 2020 continued to favour the momentum drivers of the last decade, we expect this could be the last gasp of the cycle. We believe undervalued companies are set to perform from here. Despite a challenging year and disappointing relative last two years, over a five-year time horizon – which we believe is the minimum to judge effectiveness in today's markets – the fund has returned 11% versus the SWIX return of 6%. We remain committed to our time-tested pragmatic value investing approach.