Quarterly commentary

Kagiso Islamic Equity Fund
December 2019

KAGISO Asset Management

The fund was up 4.7% this quarter outperforming the average of other general equity funds (up 4.4%). The fund has returned 7.7% pa over the last three years, which is ahead of the peer group average (3.7% pa) and is ranked thirteenth in its peer group of 131 funds. The fund has returned 10.8% pa since its inception in 2009.

Economic backdrop

Global economic growth, though still reasonably buoyant, has decelerated further from the high rates of recent years especially given a continuing moderation in Chinese growth. Increased US trade tariff uncertainty seems to have caused sustained weak business confidence, particularly in the global manufacturing sector (especially in Europe and Japan). Growth expectations have recovered moderately as weak industrial production is being offset by consumption growth, which remains healthy due to sound labour markets. Major central banks have abruptly ended their tightening and begun loosening monetary policy, as well as signaling more accommodation should economic activity deteriorate.

US economic activity has been moderate, but, despite healthy consumption and a recovering housing sector, weaker manufacturing production (due to trade tensions) and the waning of fiscal stimulus effects is now weighing on growth.

In Europe, generally strong consumption and good growth in France, Spain, Ireland and Greece is partially offset by very weak manufacturing activity, particularly in Germany. This is affected by slower Chinese growth and a contracting global automotive market. Manufacturing in Japan has been similarly affected and near-term local consumption will now be weaker post a consumer tax hike. In both Europe and Japan, industrial weakness is being partially offset by increased fiscal stimulus.

Overall growth in China remains healthy but continues to moderate as the government acts to rebalance the economy and reign in credit excesses and as export growth is affected by increased trade tariffs. Infrastructure investment and manufacturing-related growth is most affected, although the economy is benefitting from domestic stimulus.

Emerging market growth has eased in line with slower global growth but remains healthy, particularly in Indonesia and Brazil. South Africa, Russia and Turkey remain the laggards. Sharply falling inflation expectations allowed for an aggressive rate cutting cycle in 2019.

In South Africa, growth slowed notably in the third quarter with persistently low business confidence, contracting fixed investment and lackluster consumption activity amidst a steadily deteriorating labour market. A resumption of severe electricity supply disruptions in the fourth quarter will decrease near-term prospects further. Continued progress in improving governance (strengthening of corruption fighting institutions and improving corporate governance and senior leadership at SOCs) is being accompanied by frustratingly slow economic policy action in the face of a deteriorating fiscal position.

Market review

Global markets were higher in the last quarter (up 8.7% in US dollars) with the USA (up 9.1%), Germany (up 9.6%) and the UK (10.8%) outperforming. Within emerging markets (up 11.9%), South Africa (up 13.2%, the dollar return benefiting from an 8% appreciation in the currency over the period), Brazil (up 14.1%) and Russia (up 17.1%) outperformed. 2019 has been a very strong year for global equity markets (up 28.4% overall).

In rand terms, the local equity market was positive this quarter (up 4.6%) with the resources sector (up 13.5%) outperforming - gold and platinum miners strengthened again (up 26.1% and 47.0% respectively). Standout performers included Sibanye Stillwater (up 71.1%), Impala Platinum (up 50.6%) and Northam Platinum (up 48.7%).

Financials were up 2.8% with life insurance (up 5.2%) outperforming and banks generally weaker (Nedbank down 5.5%, Standard Bank down 3.6% and Absa Group down 2.3%).

Industrials were down 0.1%). Among large companies, British American Tobacco (up 6.3%) was again strong, while MTN (down 14.3%) and Richemont (down 1.9%), underperformed. Naspers was flat (down 0.2%), outperforming its underlying exposure to Prosus (down 4.8%). Retailers were mixed, with Woolworths and Truworths underperforming (down 11.8% and 7.2% respectively) and Clicks and Mr Price outperforming (up 19.3% and 15.3% respectively). Telkom (down 50.7%) was particularly weak.

The local market was positive for the year (up 12.1% following an 8.5% contraction in 2018) with divergent sectoral performances. Industrials were up 11.2%, financials were flat (up 0.6%) and resources were up 25.3%.

For several years, extreme and unconventional monetary stimulus in the form of price agnostic asset purchases have distorted asset prices across the globe. Global bond yields have retreated to very low levels (pricing in exceedingly low levels of future long-term inflation), corporate bond credit spreads are depressed, and equity prices are high, especially in large cap stocks and sectors where growth prospects are well appreciated.

US bond yields are moderately higher than the record low levels of 2016, accompanied by tentative signs of wage-led rising inflation (although yields in other developed markets are close to record lows). Recent trade tensions between the US and its key trading partners has negatively impacted the global growth outlook and central banks are undertaking pre-emptive easing measures in an attempt to avert material economic deterioration.

Fund performance and positioning

Strong local equity contributors this quarter included Northam Platinum, Omnia, Royal Bafokeng Platinum and Mediclinic. Key detractors included Adcorp, PPC and MTN

Our global equity holdings contributed to performance with key positives being Spire Healthcare, Siemens, Evonik, Nisshinbo and Bodycote. Detractors were Dupont De Nemours, Covestro and Johnson Matthey.

Despite a global backdrop of reasonable, but weaker, economic growth(as Chinese economic growth continues to trend lower) and a very weak local economy, we remain positive on the outlook for our equity holdings, given very attractive market ratings relative to our assessment of their prospects.

With the outlook for the South African economy remaining weak in the medium term, we continue to hold material positions in unpopular or neglected areas of the SA equity market where we find idiosyncratic investment cases offering improving prospects that are not wholly dependent on the economy performing. We have high exposure to mid-cap industrial stocks where we see compelling stock-specific potential, coupled with low market prices. Over two thirds of our SA equity exposure across our funds lies outside of the top 50 largest shares.

We maintain a position well below maximum permitted limits in offshore markets, mainly due to the very exciting expected returns we see in our South African holdings. Our global stock picks are widely diversified across (mostly) developed markets and have somewhat of a quality cyclical orientation. These stand to benefit from a less negative economic environment than is reflected in their very low share prices.

We are optimistic that more normal financial conditions are proving to be a much better environment for stock picking. We retain a particularly high exposure to a selection of local mid-cap stocks which offer compelling upside from a number of diverse stock specific factors that are providing positive performance, uncorrelated to the general market, and some of them (like Omnia) are new positions in the fund.

Omnia is a diversified chemical group that supplies chemicals and specialised services to the chemical, mining and agricultural sectors in Africa and has generally delivered good returns on capital over the long-term. The business has spent a considerable amount (in excess of R5 billion) on new investments, which we expect to result in meaningful cost savings. The company underperformed materially in 2019 due to cyclical headwinds in several of their end markets and a weak balance sheet following years of heavy investment (and poor working capital management). The company was forced to do a rights issue presenting an attractive opportunity to build a meaningful position in our funds.