Kagiso Stable Fund
September 2021

The fund was up 2.7% in the third quarter, ahead of its (CPI + 2%) benchmark of 2.3%. This was mainly as a result of positive performance from our yield assets. Since its inception in 2011, the fund has returned 8.3% pa.

Economic backdrop

Rapid rollouts of effective vaccines have been substantially completed in most developed markets and normal activity is resuming in those regions, limiting further scarring in services sectors (particularly tourism and leisure). Unfortunately, lingering vaccine hesitancy and slow vaccine rollout programs among less wealthy nations is delaying economic recovery. It appears that the virus will remain endemic in years to come, albeit with significantly reduced danger to society.

In the near-term, it seems that many developed economies are growing at above trend levels post their pandemic recoveries. This stronger demand backdrop together with the disruptive effects of past lockdowns is resulting in severe temporary logistical challenges and supply shortages in certain electronic components, energy sources, commodities and labour markets. Enduring economic trends may be visible only when fiscal support and monetary stimulus tapers off more meaningfully and when supply chains are functioning more normally.

Following a rapid resumption of economic activity back to pre-crisis levels, the Chinese economy has slowed somewhat due to energy shortages, supply constraints and isolated hard lockdowns. Chinese government interventions in many areas of its economy, which are aligned with its longer-term planning, are proving very disruptive. It is targeting more inclusive and less financially risky growth, carbon emission reduction and technological independence.

The South African economy has continued to recover slowly and in an uneven fashion, with high commodity prices (particularly platinum group metals, iron ore and coal) significantly supporting economic growth. High soft commodity prices, a favourable exchange rate and good weather are substantially buoying the agricultural sector. South Africa is lagging the global recovery considerably, showing signs of permanent economic scarring from lockdowns and years of state mismanagement. We have very high unemployment, a large unskilled population, unstable electricity supply, underinvestment in key transport infrastructure, weakened and revenue-hungry municipalities and chronically low business and investment confidence. For these reasons, and the very large government debt burden, we remain pessimistic regarding the structural growth rate for the local economy.

While economic revival plans are well articulated, they still rely too heavily on implementation from weakened state institutions, do not draw sufficiently on private sector co-operation and are still hampered by political unwillingness to take unpopular but necessary actions. The failure to hold the line with regards to critical government sector wage negotiations recently is a prime example. Recent actions to liberalise private sector electricity production are a modest step in the right direction. In addition, actions to rebuild crime fighting and tax collection capabilities are now bearing fruit with progress evident on both fronts.

The medium-term outlook for emerging economies is extremely varied at present, with differing exposures to volatile energy prices (importers versus exporters), strong commodity prices, the decimated tourism industry and differing impacts from the management of the pandemic and efficacy of vaccine rollouts. Due to recovering domestic demand and some signs of increased inflation, policy interest rates have started normalising higher from the extraordinarily low crisis levels.

Market review

Global markets were flat in the quarter (up 0.1% in US dollars), with Hong Kong and Germany underperforming (down 14.1% and 4.0% respectively) while the USA (up 0.6%) and Japan (up 2.7%) outperformed. Emerging markets were weak in the quarter (down 8.0%), with particularly poor performances from China (down 18.1%) and Brazil (down 19.5%).

In rand terms, the local equity market was down 0.8% in the quarter, with mid-caps (up 7.2% for the quarter versus large-caps down 1.5%) outperforming again. Resources stocks were weak (down 3.8%) in the quarter. RBPlats (down 22.0%), Impala Platinum (down 22.0%), African Rainbow Resources (down 17.9%) and Northam Platinum (down 17.3%) underperformed, while Sasol (up 30.9%) and Glencore (up 18.7%) outperformed.

Industrials underperformed (down 5.1%) - primarily due to Prosus/Naspers. Standout positive performers included Aspen (up 68.8%), MTN (up 36.9%) and food and drug retailers (up 9.5%). Prosus/Naspers (down 16.9%), AB Inbev (down 16.8%) and The Foschini Group (down 14.1%) all lagged.

Financials outperformed (up 12.7%), with listed property (up 5.9%), banks (up 15.0%) and life insurance (up 11.8%). Liberty (up 52.2%), Old Mutual (up 24.6%) and Investec (up 22.8%) outperformed, while Hammerson (down 11.7%), Fortress B (down 8.6%) and PSG Group (down 7.0%) underperformed.

Extremely high developed market fiscal and monetary stimulus, which are being sustained (and in the case of the USA, increased) into the recovery phase, are providing a powerful support for financial markets and have led to dramatic increases in general asset prices. We expect increased volatility when fiscal stimulus inevitably wanes, if inflation emerges at last and when interest rates rise from their extremely low levels.

SA bonds returned 0.4% for the quarter underperforming cash (which returned 1.0%). Globally, bonds weakened. US Treasury yields rose amidst currently higher inflation and signals for the imminent tapering of asset purchases. Foreigners continued to be net sellers of SA bonds in this quarter.

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At their last meeting, the SARB kept the repo rate on hold at 3.5%. Comments from Reserve Bank members show a slightly more hawkish tone. The inflation outlook, despite upward pressure from the oil price and food prices, should remain within the Reserve Bank's target in the medium term. This would suggest that the Reserve Bank has some flexibility on its path to rate normalization and may delay hiking in order to support the very weak economy.

Fund performance and positioning

Strong performance from our local equity holdings together with positive contributions from yield assets (property and cash) were the main contributors to performance. The key positive contributors in the quarter were key mid-cap holdings (Omnia, Datatec, Metair, Brait, Altron and Master Drilling) as well as MTN. Detractors were primarily PGM miner holdings.

Our global equity holdings contributed negatively to performance. Detractors included Nisshinbo Holdings, Bayer, Dupont De Nemours, Siemens Energy and Associated British Foods. Prudential, Inpex, Nutrien, Siemens and Bodycote contributed positively.

- We have a high exposure to South African government bonds due to very attractive real yields on offer.
- We remain guarded on corporate credit exposure with relatively low credit exposures, mainly in short-term credit instruments of well-capitalised financial sector companies.
- We remain highly selective within listed property, although maintain high exposure to certain preferentially positioned A-shares.
- We maintain a high level of equity market hedging, given generally high market levels, and to enable high gross exposure to our best stock picks.

Our portfolios contain a diverse selection of local mid-cap holdings offering very attractive upside.

Master Drilling specialises in raise bore drilling, which offers mining companies a mechanised, safer and significantly cheaper alternative to conventional blast drilling. The group specialises in in-house drilling equipment design, manufacturing, training and maintenance capabilities, allowing them to tailor solutions to meet the specific drilling requirements of customers. Master Drilling has invested significantly in increasing the size of its fleet by over 60% since its listing in 2012. This coincided with the top of the last mining boom cycle and preceded a significant reduction in commodity prices and capital investment by mining companies. This led to reduced capacity utilisation of its fleet and lower margins. While commodity prices have recovered strongly since 2016, mining companies' capital expenditure has lagged and remains at unsustainably low levels. As this situation normalizes, Master Drilling will benefit substantially from higher capacity utilisation and margins.

Within equities, we maintain our high exposure to low-cost, growing PGM miners. We expect a sustained shortage in PGM metals when global economic activity normalises after the current logistic and supply challenges. There is growing demand from tightened emission regulations, increased jewellery sales and a rapidly growing hydrogen energy sector. Current share prices offer very attractive near-term free cash flow yields.

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