Kagiso Stable Fund
December 2021

The fund was up 6.1% in the third quarter (ahead of its (CPI + 2%) benchmark of 1.2%) and up 23.1% over the past year. This was mainly because of positive performance from our local equities and yield assets. Since its inception in 2011, the fund has returned 8.7% pa.

Economic backdrop

Although the global economy has largely recovered from the COVID-19 pandemic shock, the recovery is very uneven across countries and sectors. Despite high vaccine efficacy, new virus variant waves continue to impede a full recovery due to government containment measures. The pandemic has severely impacted manufactured goods supply chains and this is contributing to supply shortages and to higher inflation rates. 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.

Developed economies are growing above pre-crisis trend rates for now, despite the supply chain disruptions and even as fiscal stimulus benefits rapidly wane. This is due to healthy consumer spending stemming from robust labour markets, accumulated savings from lockdown periods and surging wealth levels.

Chinese economic growth has now slowed due to its property market excesses unwinding following regulatory interventions, 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 (and congruent with sustainably high longer-term growth) are proving very disruptive in the short term. These interventions are targeting more inclusive and less financially risky growth, corporate monopoly positions, carbon emission reduction and technological independence.

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

Although economic growth has rebounded as expected, the South African economy will continue to produce only moderate expansion from here, despite notable strengthening of the primary sectors (mining and agriculture). Scarring from years of state mismanagement and the pandemic lockdowns is highly evident in consumer spending, manufacturing capacity and fixed investment. There is a risk that future less buoyant commodity prices (particularly platinum group metals, iron ore and coal), which are currently strongly supporting the economy, will result in an even weaker outlook. In addition, South Africa continues to battle burgeoning unemployment, a large and unskilled population, unstable and inadequate electricity supply, underinvestment in key transport infrastructure, weakened and revenue-hungry municipalities and chronically low business and investment confidence. For these reasons, coupled with 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. Recent actions to liberalise private sector electricity production and early steps towards enabling private sector access to freight rail network are modest moves in the right direction. In addition, actions to rebuild crime fighting and tax collection capabilities continue to bear fruit, albeit at a slow pace due to capacity challenges.

Market review

Global markets were strongly positive in the final quarter (up 7.9% in US dollars), with the USA (up 11.0%) and France (up 8.1%) outperforming and Hong Kong (down 4.8%) and Japan (down 5.3%) underperforming. Emerging markets were again weak in the fourth quarter (down 1.2%), with particularly poor performances from Russia (down 9.0%), China (down 6.1%) and Turkey (down 11.1%). 2021 was a very strong year for global equity markets (up 22.3% overall).

In rand terms, the local equity market was up significantly in the quarter (up 15.1%). Resources stocks were very positive (up 22.2%), with RBPlats (up 110.6%), Gold Fields (up 41.3%) and Anglo Platinum (up 39.3%) outperforming, while Sasol (down 9.3%) and Exxaro (down 5.1%) underperformed.

Industrials were also positive (up 16.8%), with standout positive performers being Richemont (up 55.2%), Telkom (up 22.5%), MTN (up 20.8%), Dis-chem (up 19.9%) and Shoprite (up 16.9%). Aspen (down 17.2%), Woolworths (down 12.2%) and Pick n Pay (down 7.3%) all lagged.

Financials underperformed (up 2.2%), with listed property (up 8.4%), banks (up 3.2%) and life insurance (down 4.8%). Investec (up 37.6%), Fortress B (up 27.5%) and RMI Holdings (up 20.7%) outperformed, while Momentum (down 9.3%), Old Mutual (down 7.6%) and Sanlam (down 7.1%) underperformed.

The local market was positive for the year (up 29.2%). Resources were up 32.4%, financials were up 27.4% and industrials were up 24.7%.

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SA bonds returned 2.9% for the quarter, outperforming cash (which returned 1.0%). Globally, bonds weakened. US Treasury yields rose amid the currently higher inflation and signals for the pace of tapering of asset purchases and interest rate increases. Foreigners continued to be net sellers of SA bonds in the quarter.

At their last meeting, the SARB increased the repo rate by 0.25% to 3.75% in the face of rising near term inflation and the risk that it may become persistent. 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 in our view. This would suggest that the Reserve Bank has some flexibility on its path to rate normalisation and further hikes may be slower than current market pricing suggests 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. Within local equities, the key positive contributors included: Anglo Platinum, Anglo American, Datatec and MTN. Detractors were primarily from our mid-cap holdings (Metair, Altron, Oceana, Crookes Brothers and KAP).

Our global equity holdings contributed only moderately to performance. Detractors included Aroundtown, Johnson Matthey, Prudential and Zimmer Holdings. Inpex, Dupont, Nutrien, Associated British Foods, Siemens and Evonik all 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 currently have high exposure to PGM miners, chemical producers, global media and a diverse range of selected local mid-cap stocks.

Omnia is a diversified chemical group that supplies chemicals and specialised services to the chemical, mining and agricultural sectors in Africa. Fundamental drivers for its mining and agriculture business have strengthened materially over the last two years and should support significant earnings growth over the medium term. We are particularly positive about the growth opportunity within its speciality fertiliser (humates) business. Globally we are seeing a structural shift to biological fertilisers and away from nitrogen-heavy fertilisers that are a major source of greenhouse gas emissions. Omnia is well placed to capitalise on this shift as it owns one of the world's richest deposits of humic acid in Australia. The humates market is growing quickly and unlike its traditional fertiliser business, is characterised by high margins and low capital investment - and therefore high returns. The growth outlook for the humates business is excellent and Omnia has recently doubled capacity. We see the potential for capacity to double again over the medium term and expect this business to contribute meaningfully to valuation over time. Longer term, earnings should be supported by growing asset utilization across the business. Omnia has spent more than R5 billion on new investments (manufacturing facilities and acquisitions) over the last few years, with many of the cost and synergy benefits still to be realised. A stronger focus on sweating its asset base should see returns improve further from current levels and will unlock further incremental value for shareholders.

We maintain a weighting in Prosus, which has a strong balance sheet and the underlying exposure to online Chinese economic activity (via Tencent) has a bright, long-term future. The company is thriving in the current economic environment, as evidenced by recent results and there is considerable upside at the current share price in our view.

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