EFFECTUS
CAPITAL MANAGEMENT

NEWSLETTER

FEBRUARY 2020

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GLOBAL OUTLOOK 2020

Effectus Capital Management Base Case

A healthy correction is overdue however we feel this will not derail the overall economic outlook for the US. Corporate profits will remain strong and ultimately equity market supportive as the ongoing benefits of productivity and innovation gains feed through into company profits. Therefore, we expect the US to remain in a bull market with some form of correction along the way.

We expect ongoing and coordinated fiscal stimulus efforts by global authorities to continue, especially considering the Coronavirus impact on China (and global) growth. Commodities will remain supported by a slow and steady global growth paradigm, along with sustained fiscal and monetary stimulus.

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RISKS TO THE REMAINDER OF THE YEAR

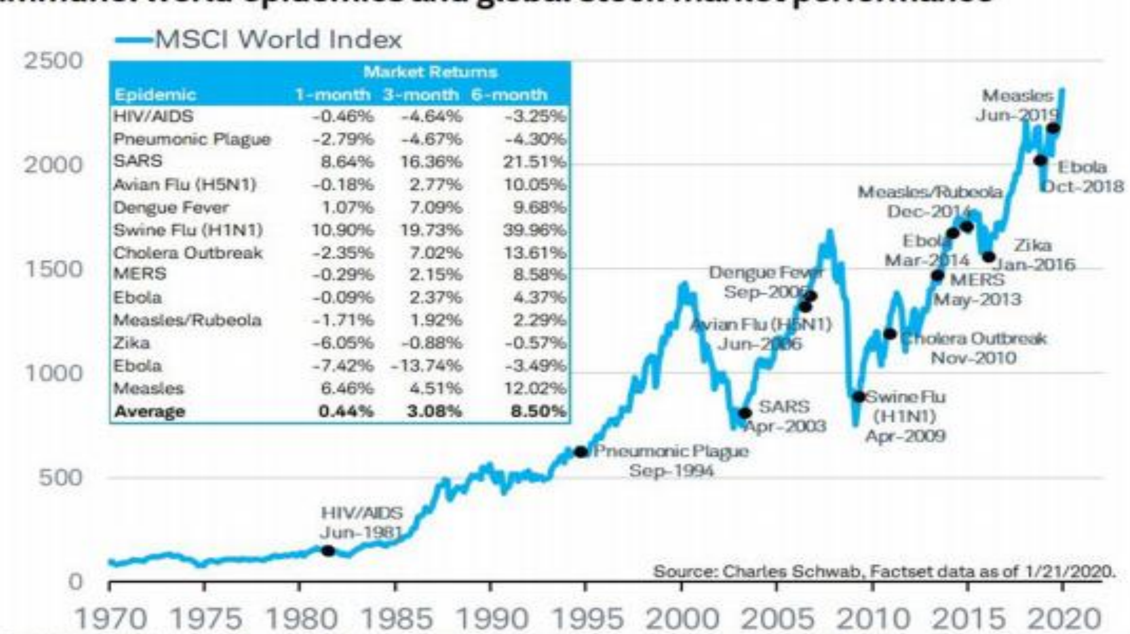
- **Inflation surprise:** an unexpected upswing in inflation is possibly one of the greatest risks to global monetary stability given the magnitude and ease of prevailing monetary policy globally. Our base case view is for a continuation of low inflation supported by the ongoing globalisation of manufacturing and distribution, demographic trends such as urbanisation, and the rapidly accelerating productivity, innovation and technology virtuous cycle. Furthermore, it is worth noting the almost invisible impact of the tariffs emanating from the trade wars in 2019.

- **Surprise election outcome**: Despite all the controversy, Donald Trump has been and remains, good for the markets. A surprise Democrat outcome by the likes of Bernie Sanders or Elizabeth Warren will likely result in an unfavourable or at least unpredictable market reaction.

- **Sustained bubble-like rally in US markets** driven by inflating multiples that further decouple from earnings. The record liquidity pool and cheap capital are key culprits in this scenario. The ensuing sell-off will be painful not only to the US but also to global markets.

- **What about the COVID** – 19 Virus? Historically these viral outbreaks which tend to occur every few years have proved to be good buying opportunities.

Immune: world epidemics and global stock market performance

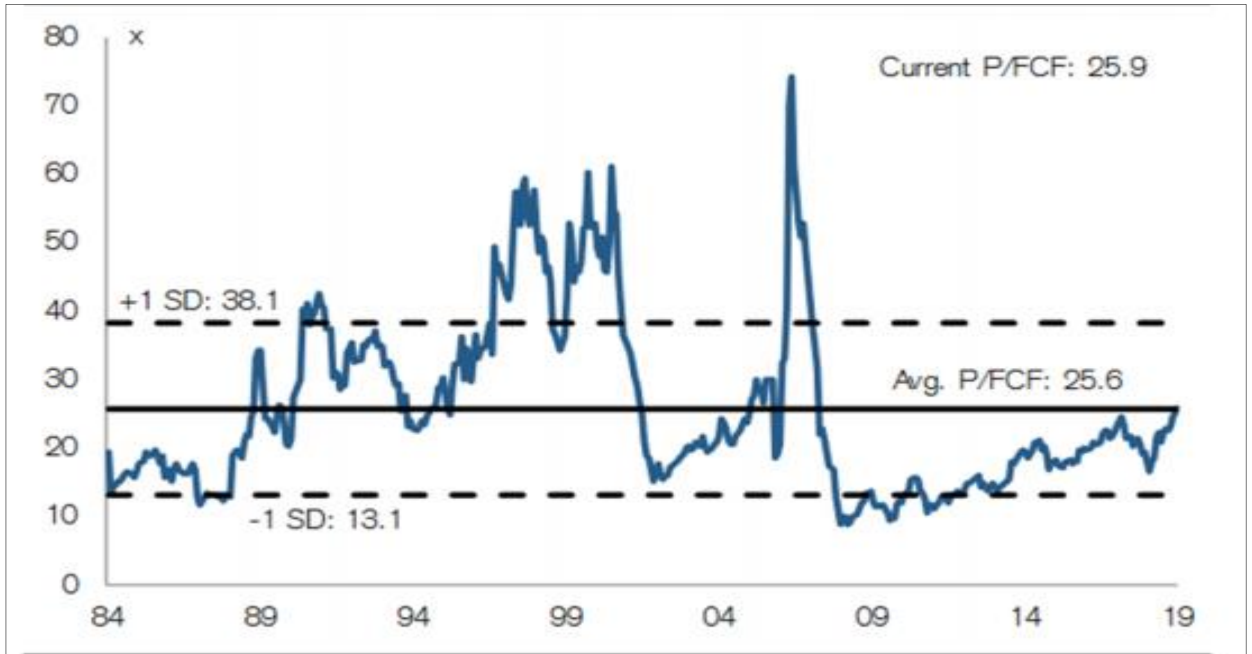


	Market Returns		
Epidemic	1-month	3-month	6-month
HIV/AIDS	-0.46%	-4.64%	-3.25%
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	8.64%	16.36%	21.51%
Avian Flu (H5N1)	-0.18%	2.77%	10.05%
Dengue Fever	1.07%	7.09%	9.68%
Swine Flu (H1N1)	10.90%	19.73%	39.96%
Cholera Outbreak	-2.35%	7.02%	13.61%
MERS	-0.29%	2.15%	8.58%
Ebola	-0.09%	2.37%	4.37%
Measles/Rubeola	-1.71%	1.92%	2.29%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-7.42%	-13.74%	-3.49%
Measles	6.46%	4.51%	12.02%
Average	**0.44%**	**3.08%**	**8.50%**

The MSCI World Index captures large and mid cap representation across 23 Developed Markets countries. With 1,646 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. **Past performance is no guarantee of future results.**

Source: *Charles Schwab*

- **The roughly 30% rally in US stocks in 2019** was driven largely by multiple expansion which means that corporate earnings need to at least meet or exceed expectations through 2020. While such multiple expansion increases the risks, the market is not overpriced looking at a Price to Free Cash Flow basis:



Note: Russell 1000 prior to 1990, S&P 500 after 1990
Source: Standard & Poor's, Russell, Thomson Financial, FactSet, Credit Suisse

Source: FACTSET

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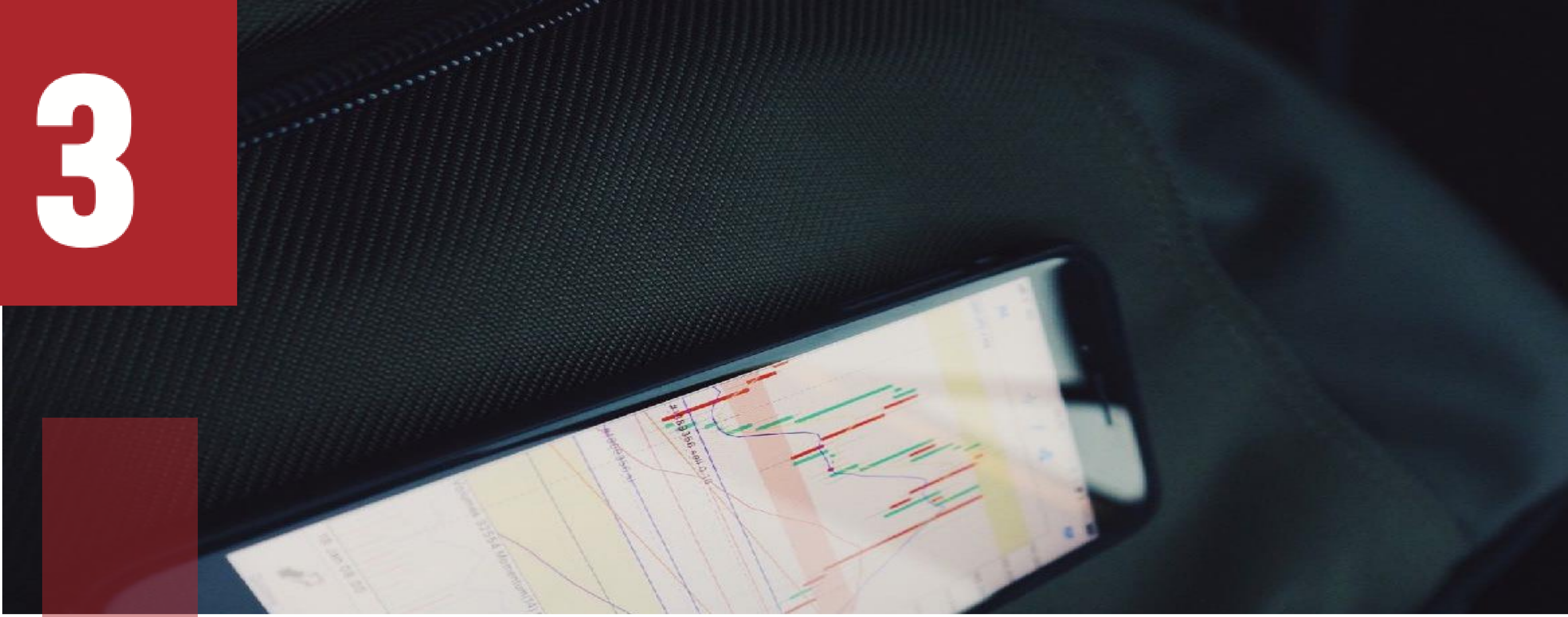

CONSENSUS TRADES THAT WE ARE WARY OF

Time and again we have seen consensus trades rapidly unwind. Some that we are watching out for with interest:

The new supply and demand dynamic of PGM metals such as palladium and rhodium.

The US markets will underperform EM. This story has been 3 years in the telling and EM is currently around 17 year lows relative to DM. Balance of probabilities suggest this mean reversion trade has a good probability but the catalyst is not obvious.

The US dollar will weaken. With an economy that is plugged in to global growth and by far the leading corporate collective in terms of productivity and innovation the USD may well strengthen once again as key currency alternative such as EUR and JPY remain structurally weak.

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SOUTH AFRICA

In the absence of major structural reforms we see a continuation of the stagnant growth outlook. The lack of a unified political will (or ability) to make the hard but needed decisions is a large stumbling block to change. We expect that a downgrade by Moody's is of a very high probability and should be largely priced into our bonds and equity markets by now.

There are a few binary-style events that could take place in SA such as a sudden clamp-down on corruption and/or some form of positive Eskom outcome.

The fact is the outlook for SA is not attractive but there is certainly room for a positive surprise coupled with relatively low valuations.

SA on a sector level

In line with our positive global growth outlook, we remain constructive on **industrial and base commodities.**

While the **PGM basket** price has a number of supportive supply and demand factors (such as an ongoing supply deficit in palladium) we cannot help but think the recent price actions looks and feels very much like a bubble. One need just recall the 2007-2008 commodity and oil price bust. We are not bearish PGMs but rather we are wary of 'this time its different' accompanied by a vertical price chart.

Charts of Amplats and Rhodium going back to the 2008 peak period. Risk rewards are looking skewed.

Given the latent risk such as US election outcomes, COVID-19, $17 Trillion in negative yielding assets, we think its worth holding some **gold** as an inflation and risk hedge.

The global outlook is more favourable than that for the SA economy and we therefore still favour some of the **global industrial companies** with offshore earnings as both a defensive rand hedge and a play on global growth.

The slow growth in SA at a time when the rest of the world is growing highlights the deep structural problems.

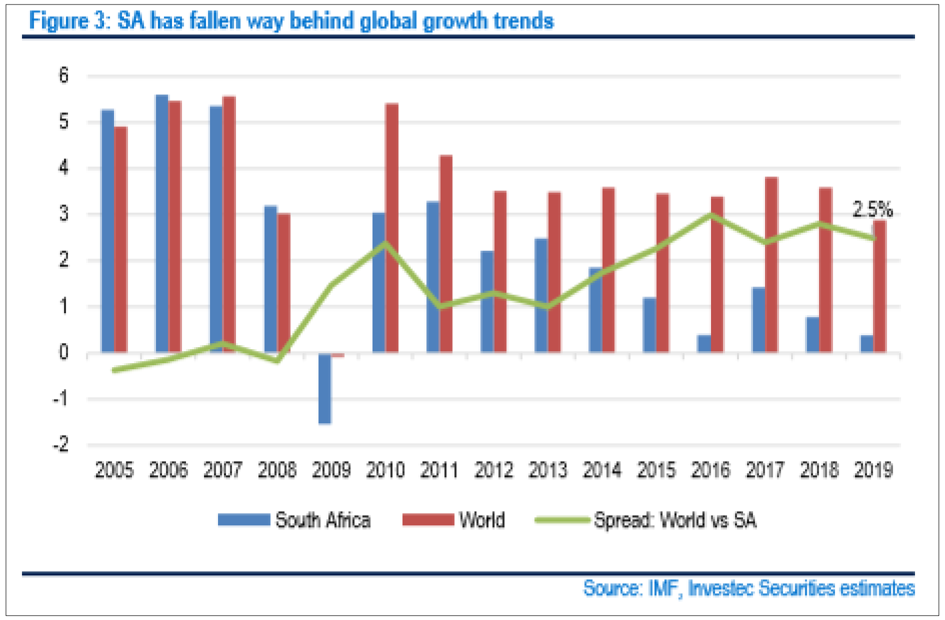


Figure 3: SA has fallen way behind global growth trends

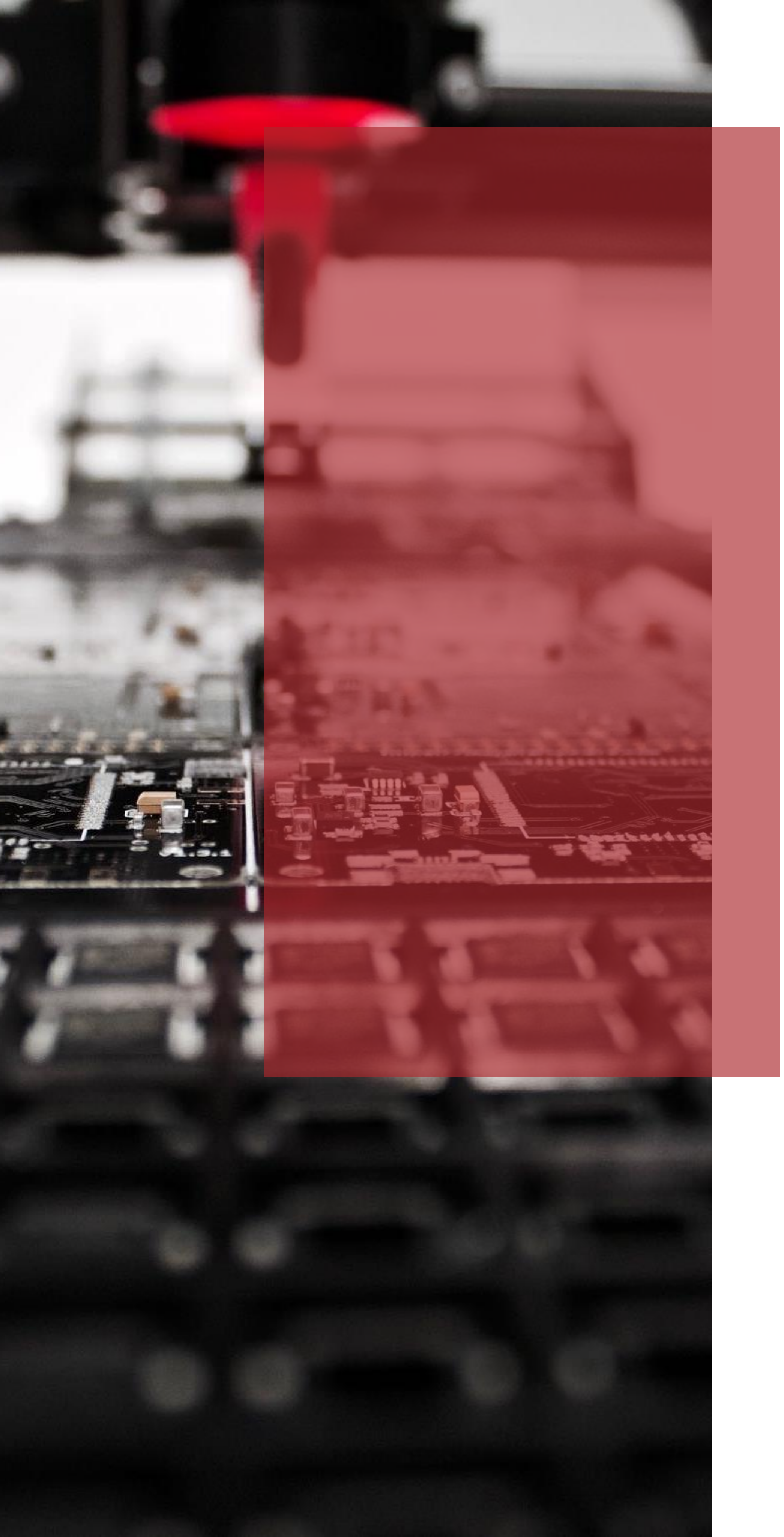
Source: IMF, Investec Securities estimates

The overall outlook for South African focused companies will likely remain constrained across the board. Very few sectors will exhibit real economic growth and expansion. In this context we believe the outlook for the year is going to be more about which companies are growing and innovating thereby taking relative market share in a limited pool of opportunity. Poor balance sheet and poor operators will continue to be found out.

Financial services are likely to remain under pressure. The consumer credit space has no room to grow with such constrained real wage growth, while corporate SA perhaps healthier, there is not a lot of new activity as opportunities to deploy capital are scarce. Having said that, the defensive nature of the SA banking sector is such that when valuations move toward multi-year lows (as they are) this presents an opportunity.

Negative reversions in the **local property** market have not yet bottomed out and although yields are looking attractive, we prefer to stay out of a sector whose fortunes are being impacted not only by the economy but by significant changes in consumption habits. In fact the apparent dividend yields are unlikely to be sustained going forward. Similarly, we prefer to avoid the highly concentrated Eastern European retail exposure evident in the property sector. It surely is a matter of time before global retail and property trends find their way into Eastern Europe.

The entire **retail space** is constrained by persistent pressure on real disposable income making the collective retail an area of stagnant growth. The discretionary pool of spending is arguably even decreasing as the low CPI hides the impact of high administered and other costs. The more defensive non-discretionary is preferred and once again those who can capture market share are likely to outperform.



CONCLUSION

The more complex the outlook and various scenarios are, the more it pays to focus on a few key factors and to keep it simple. We note that the level of pessimism around the SA outlook as the stream of GDP downgrades continue. The pockets of value are there to be seen but the ultimate question remains – are they pockets of value or are they value traps. We believe there are some opportunities where the risk reward makes sense, but only in the high-quality names. Companies that can capture market share in an operating segment of stagnant growth and service debt and dividends comfortably. The poor outlook for SA is clearly a consensus trade.

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