EFFECTUS
CAPITAL MANAGEMENT

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Effectus Capital Management (Pty) LTD • FSP Number: 50016 • Registration Number: 2015 / 281719 / 07

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By Grant Nader

Finally, the election is behind us and we can focus on the things that really matter in long term investing, such as the economy and earnings.

What people say in public and what they think are not always the same. I think the fact that it is 'un-pc' to support Trump once again led to a massive miss-poll. Putting the polls aside, it was really interesting to see how the election rhetoric changed over the course of the year with respect to the market narrative and positioning:

- Trump is good, Biden is bad for markets (first quarter of 2020)
- Biden is good for stimulus, infrastructure and banking, renewable but bad for big tech and healthcare
- Trump is better for big tech and corporates than Biden, but bad for renewables
- A Democrat clean sweep is better able to pass massive stimulus so good for markets – but bad for dollar and tech and bad for corporate taxes
- A contested vote will be really bad for markets who don't like uncertainty
- The list goes on…

After all the noise, the message is…pay attention to what really matters…the fundamental economic outlook and what corporate earnings growth will look like. It doesn't pay to position massively for unknown, short-term outcomes. Investing is not about making massive short-term bets - going to cash then back to stocks at just the right moment is a game very few can play (see March lows for reference!)

So what are fundamental drivers in place looking ahead?

As usual we touch on some of the more relevant or interesting observations we are making.

Money printing and QE

The monetary and fiscal expansion continues with the Fed balance sheet now over $7 trillion, up from $4 trillion in February of this year, catalysed by the March 15 QE announcement. This coincided with market lows and remains a key force behind the stock market.
Their commitment to keep rates lower for longer, rather risking inflation upside is risk asset supportive.

The **slowing marginal propensity to consume** means that the velocity of money has slowed. The impact that another $1 of debt has on the economy continues to decline making **monetary policy less and less effective**. Government bonds now have an unattractive risk-reward profile in the event that we do see some inflation.

The net effect is mainly to drive savings and investment into paper assets such as equities, corporate bonds, and some hard assets such as property.

Fiscal stimulus

The amount of stimulus may be lesser or greater depending on who is in power, but the universal need for, and commitment to delivering fiscal stimulus means that this critical component of future growth remains in place. This is a global phenomenon that will continue to be supportive of the uneven global economic recovery. Primary beneficiaries are likely to be commodities and other cyclical assets.

US and Global Economic indicators

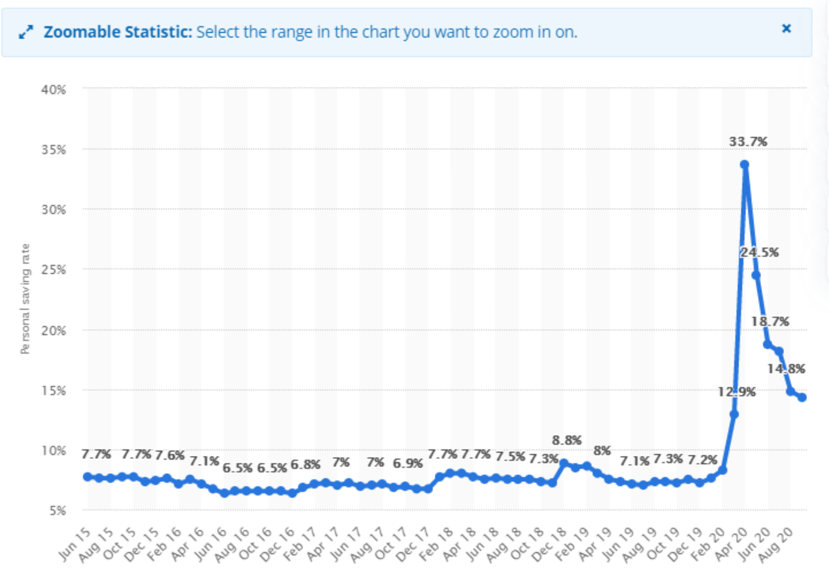
The "I am still employed" effect

Our view at ECM is that for those who have kept their jobs through the crisis, in many cases, their situation has improved (see personal savings rate below) thanks to a number of factors:

- home loan, car or other debt repayments have fallen with the dramatic interest rate declines
- monthly consumption expenses have declined – movies, eating out, recreational activities etc
- far less services have accessible and available for consumption such as nails, haircuts, massages
- Government cheques in the mail (in some cases) have increased disposable income and been applied to reducing debt

The personal savings rate in the US still sits above 14%, well above historic levels. This is supported by the ongoing government stimulus and the fact that uncertainty drives conservative behaviour. We continue to believe that as consumers become more secure in the future economic outlook and recovery, this significant pent up consumption demand will unwind and further drive the recovery (the US economy is 2/3 consumption driven).

The effect of this **global pent up demand will continue to unwind** and provide support for the economy as people become more accustomed to life with the virus (just take a walk through the local mall to see this).



The unemployment rate in the US is back below 7%, less than half of the peak. This is another positive indicator and supportive of the recovery.

The housing market boom continues in the US and we believe this is likely to last a number of years due to a couple of factors:

- The Millennial generation is coming of age and household formation is becoming a priority
- Record low interest rates make house ownership far more affordable
- The large increase in company's willingness to let employees permanently work from home has led to more demand for homes outside of the major urban centres and cities.

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Global inventory restocking continues leading to demand surges and is helping drive further recovery
Still no real sign of inflation – this is critical in the outlook for rates and equity markets in general. We are keeping a close eye on this.

China is on track to record an incredible GDP growth this year of over 4.5%. We must not lose sight of the importance of this statistic as it's the second largest economy in the world and does not exist in a vacuum (that is, the strength of China and indeed Asia will help the global recovery).

On the negative side, Europe continues to struggle with the virus which only serves to add to the long list of structural challenges they already have.

The changing face of Emerging Markets

I can still remember the days when emerging market investing was all about commodities risk on and commodities risk off (in fact that is still the narrative for many today). But the world is changing, the iShares MSCI EEM Emerging Markets ETF is now dominated not by commodity companies but by technology companies who now occupy 7 of the top 10 places. The top 7 alone make up close to 30% of the entire index (see below).

iShares MSCI Emerging Markets ETF - top 10 holdings and weights

Name	Sector	Market Value	Weight (%)
ALIBABA GROUP HOLDING ADR REPRESEN	Consumer Discretionary	2 102 976 169.11	8.70
TENCENT HOLDINGS LTD	Communication	1 605 882 086.69	6.65
TAIWAN SEMICONDUCTOR MANUFACTURING	Information Technology	1 366 780 428.97	5.66
SAMSUNG ELECTRONICS LTD	Information Technology	875 118 004.41	3.62
MEITUAN DIANPING	Consumer Discretionary	487 381 455.48	2.02
NASPERS LIMITED N LTD	Consumer Discretionary	311 749 197.90	1.29
RELIANCE INDUSTRIES LTD	Energy	290 792 694.93	1.20
JD.COM ADR REPRESENTING INC	Consumer Discretionary	254 952 006.56	1.06
CHINA CONSTRUCTION BANK CORP H	Financials	242 912 469.74	1.01
PING AN INSURANCE (GROUP) CO OF CH	Financials	224 913 895.82	0.93
	Technology in top10		**29.0**

The long-term growth drivers of technology and innovation have delivered accelerated growth through the crisis. Many of the covid-driven changes are structural and will provide earnings tailwinds for many years to come.
The well know US tech leaders have garnered the lion's share of investor attention but **China (and some other parts of the world) has its own tech leaders** that fill the self-same roles as the US companies providing exciting long-term investment opportunities. These companies cover the **full spectrum of high growth trends such as e-commerce, gaming, clean-energy, robotics, genomics and more.**

Earnings

Q3 earnings have been somewhat lost in the election noise but the **vast majority of companies are reporting better than expected** results (yes there is a pattern of lowering expectations into earnings and then beating such expectations) but the trend is even stronger than in the past and over 80% have beaten expectations. The worst performers being energy, financials, utilities and real estate.

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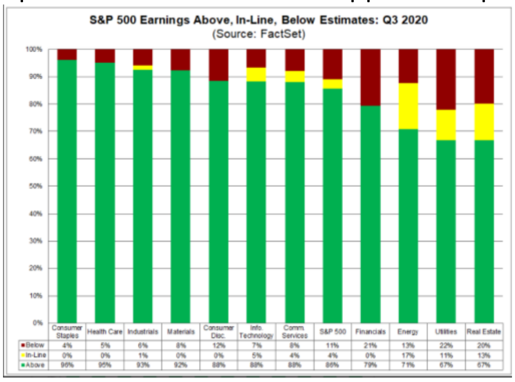
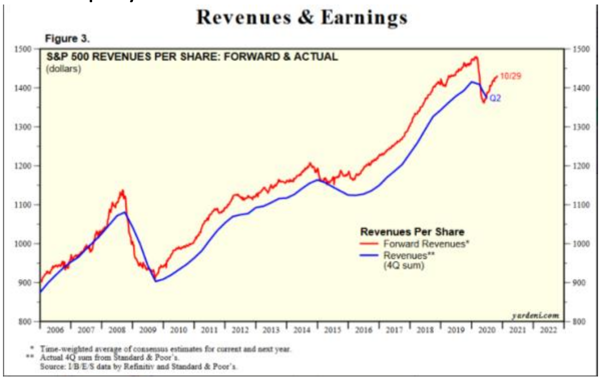
What is most important is that the **earnings trend is moving upwards** and expectations continue to be revised upwards as well….and this supports the positive equity markets outlook.





The 'kitchen-sink effect' and why we should keep buying stocks

It's a well-known strategy of most new CEOs who have been appointed to 'turnaround' or fix a company after a crisis. The first move they make is to kitchen-sink everything they possibly can, - underperforming assets are written down, divisions closed, costs expensed and provisions are raised, (the previous incumbent or crisis being the scape goat). This has the effect of **greatly increasing the chance of a future earnings recovery** (it's always easier off a much lower earnings and asset base in the world of accounting).

I have noticed most companies affected by the lockdowns (i.e. non-tech, food or healthcare) have been passing gratuitous impairments. It only makes sense to impair an asset if you believe the revenue earning capability is permanently diminished. In contrast to this most analysts and economists point to 2019 earnings-level and economic recovery taking place over 2021-2023 depending on the industry and the country. If this is truly the case, many of these 'impaired assets' will once again be generating a good deal of revenue. I think that there is a decent probability that many companies have over-impaired and thus have more upside surprise capacity than we realise.

The crisis has provided a perfect opportunity for companies to do just that (kitchen-sinking) without finger-pointing from shareholders. There is nothing better for future earnings, return on assets and return on equity than to write down unproductive assets or over-provision for risk (remember the smoothed earnings profile of banks in the pre-IFRS days?).

This greatly increases the chances of upside earnings surprises and improving profitability metrics, making this a great time to invest in companies you believe have the potential to recover to something close to what was normal earnings in the next couple of years.

South Africa

South African companies' earnings have largely been better than expected. Cash flows have been well managed and balance sheets are surviving. Clearly a large part of this has been inventory destocking (something we have seen globally), reducing the working capital cycle to its bare minimum and cutting back on any capex possible. There has also been a great deal of kitchen-sinking (discussed above). This frees up significant cash flows which are needed to weather the storm.

What are the potential implications as the economy recovers?

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- As the economy and business activity recovers, **companies will need to restock inventory** - this inventory build is a positive growth driver for the overall level of economic activity
- I expect there to be **improved operational gearing** as business resumes. Some companies have learnt to do more with less - so there is a **permanent efficiency in many of the forced survival cost savings** (for example, cutbacks on non-essential staff, reduced rental space (be it office or retail), focused advertising and marketing.
- Consumers who still have a job, have pent up consumption demand of services and good

Lastly, when thinking about South Africa we have always said most of the recovery will come from what is going on globally rather than what we are doing here. Fortunately**, the global outlook continues to improve**, notably led by China (one of our biggest trading partners), and then the US. So as the world improves ahead of expectations from a mere 6 months ago, so will South Africa.

Fund positioning

We have remained largely invested throughout the pre-election period, choosing to avoid the noise and focus on the long-term growth drivers of our investments. This has served us well and we retain this stance looking ahead.

The top performing sectors in our Global Growth and Innovation Fund:

- 5G related stocks such as infrastructure, semi-conductors
- Online media and content such as gaming and streaming
- Exposure to India's structural high growth

In our South African Equity Fund the largest contributors to performance were technology, mining and financial innovation.

Conclusion

The election has been a reminder of the importance of separating wheat from the chaff. We strive not to get distracted by peripheral noise and rather on finding great investment opportunities and emerging trends and innovations that can drive wealth creation.

The key support factors of fiscal and monetary stimulus, pent up consumption demand and low earnings bases continue to paint a positive picture of the outlook for equity markets.

Growth and Innovation thought of the month

Its certain, vaccines will come. The date is not clear, but we move closer every day to what will end up being a record turnaround time for a vaccine.

They will be major rotation and positional shifts taking place as the market players try to catch the various bounces. Yes, sectors will recover, and some stocks are cheap. However, it's all about timelines. If we are looking out beyond the next 6-12 months, many stocks and even sectors are value traps.

The lines between future growth prospects and free cash flow generation will soon cross the lines of cheap stocks and low multiples. At that point, the relative appeal that sustainable future earnings growth and innovation offers will once again outweigh that of 'it's too cheap not to buy'.

With a long-term investment horizon, we still favour the wealth creation potential that high earnings growth compounding can offer.