EFFECTUS
CAPITAL MANAGEMENT

NEWSLETTER

September 2019

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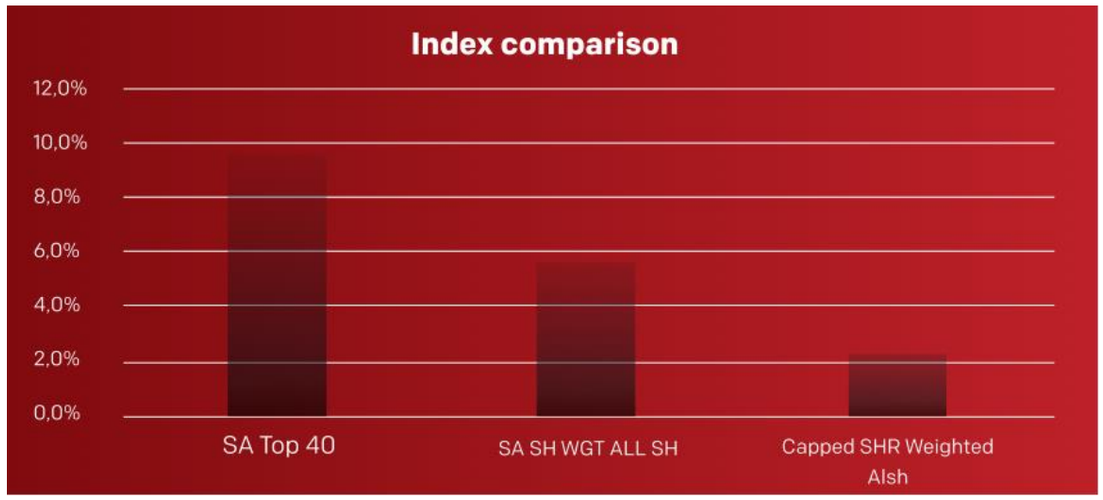
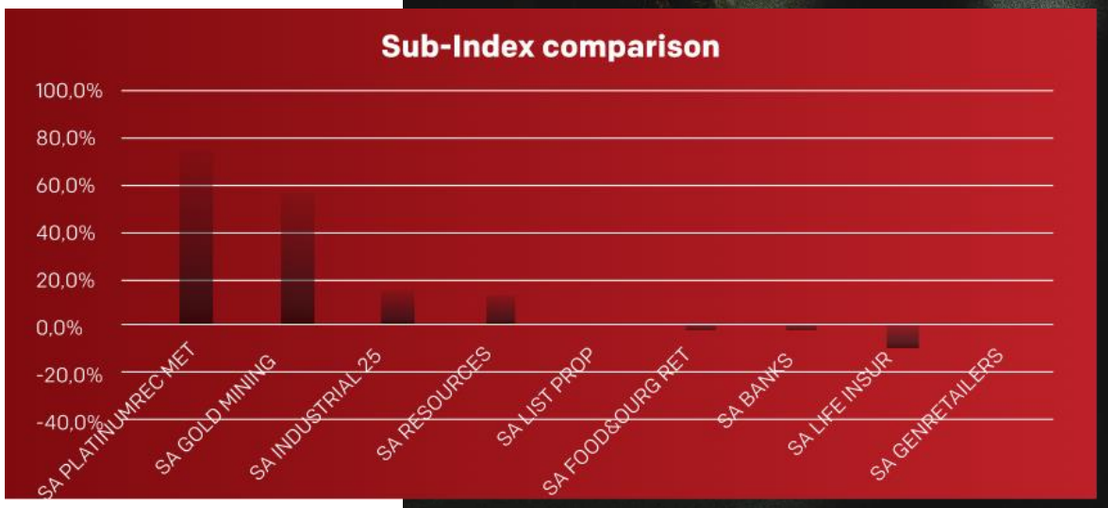
BRIEF YEAR TO DATE REVIEW

The year to 31 July has been characterised by an initially strong equity market performance on an index level which has slowly given way to global and local macro-economic factors. The early enthusiasm for SA Inc companies into the election quickly waned as the difficult reality of turning around South Africa's economic and social quagmire began to set in.

Many have been disappointed at the slow rate of change and lack of concrete action emanating from government. This can be seen from the underperformance in the most popular SA Benchmark Capped Shareholder Weighted Index against the more offshore weighted TOP40 Index.

Within all of the indices, the overall good top line performance was flattering in that it was driven almost exclusively by the resources and industrial indices. In particular, the gold and PGM counters were by far the standout performers with these indexes recording gains of close to 60% and 75% respectively.





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OUTLOOK FOR THE SECOND HALF OF THE YEAR

Global outlook and themes

Many of the same themes continue to dominate the headlines inter-alia, trade wars, yield curve inversion, economic slowdown and negative yielding bonds. We briefly outline below our view on some of the key themes.

US-China trade wars

The trade-war has become a battle of attrition as neither side appears willing to concede. The ever strategic China appears set to wait out the next US election in 2020 in the hope that Trump is not re-elected or is possibly swayed by voter pressure in the build-up. In the meantime, China have begun to weaken their currency which is their primary weapon in the trade wars. The weakening of the currency beyond the key 7 Yuan/$ level is significant, not just for the US but for the global economy as well. By making China's exports more competitive the impact on other exporting nations will conversely be negative at a time when global growth is slowing fast. We see this move as a net negative for the global outlook.

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OUTLOOK FOR THE SECOND HALF OF THE YEAR

What about the Federal Reserve and rate cut outlook?

In the face of what looks like a strong US economy, there are two different schools of thought on why the Fed is cutting rates right now: 1) the Fed must see something concerning in its data that is not yet apparent or, 2) the Fed is making a pre-emptive strike against prevailing global risks such as the trade-wars, European slowdown and Brexit, amongst others.

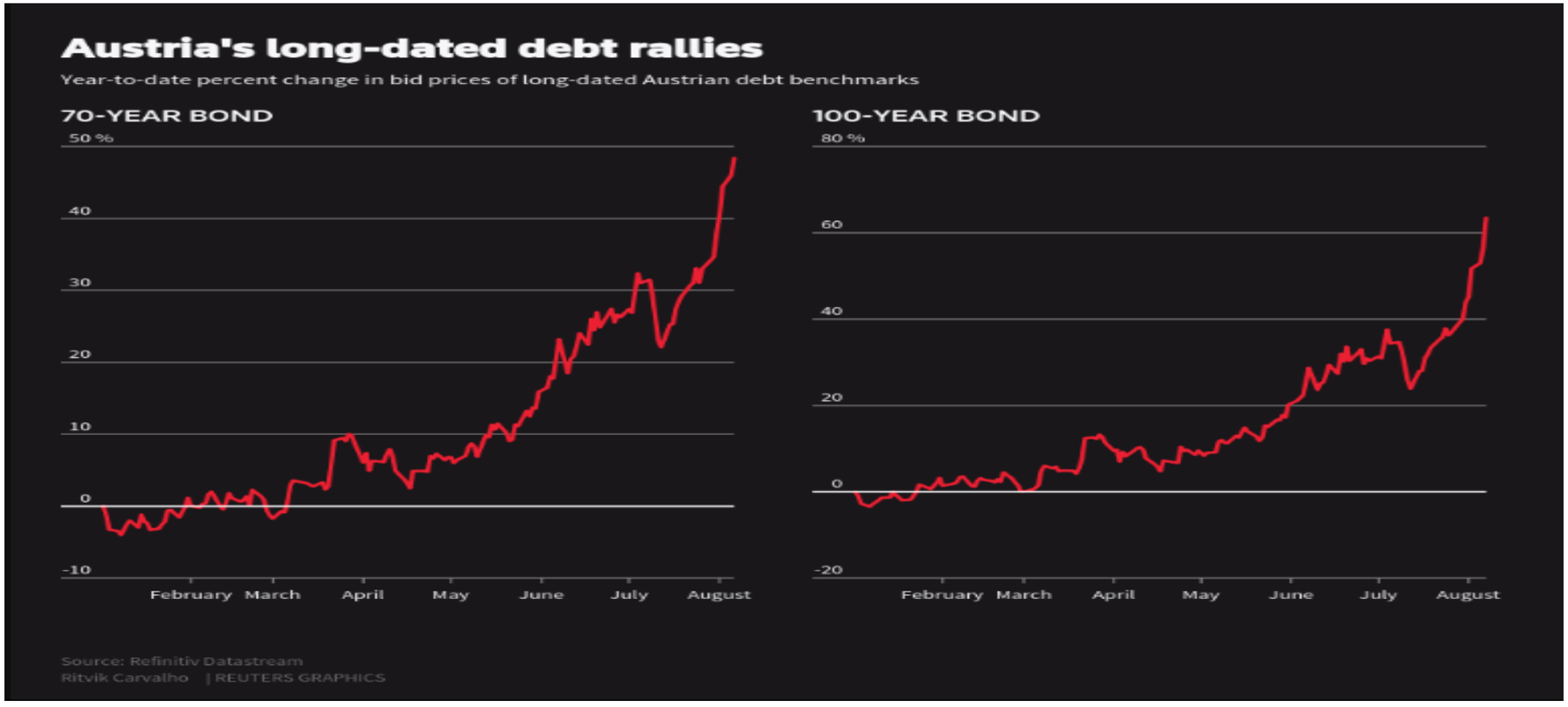
Either way, the indicators are in favour of rates declining further and critically the inflation outlook supports this. The Fed's preferred inflation measure is the PCE Core Inflation which, as can be seen from the chart below, has a high correlation with WTI Crude. The outlook for crude is soft as demand fades which is expected to keep a lid on inflation. This will give the Fed further room for rate cuts, with another 25bp cut this year almost a certainty.

European economic slowdown (and Brexit)

Europe is one of the bigger risks to global growth. The Eurozone is growing at the most marginal of rates, the last quarter having been at 0.3%. The Manufacturing PMI is trending well below 50 signaling ongoing contraction despite the ultra-easy monetary policy that prevails. Within the Euro, the major industrial engine that is Germany is showing marked signs of economic slowdown and added to this is the not insignificant risk that a 'hard-Brexit' could push the region into flat or even negative growth territory.

Negative interest rates

We have long stated that the beneficial impact of further monetary stimulus is becoming more and more marginal. It is important as we once again accelerate into a negative interest rate investment environment to understand the limited impact that this will have on global economies and also to an extent equity markets. Close to $14 trillion in sovereign bonds now trades at below 0%. The future impact on pension and retirement funds is massive and has not yet become fully apparent. The entire German government yield curve out to 30 years is now below zero. The global yield contraction is pushing investors further out the maturity spectrum, for example we now see Austria's 100-year bond up around 63% year-to-date, with a price chart resembling the bubbles in cryptocurrencies and tech stocks. The risks are clearly apparent.


Austria's long-dated debt rallies
Year-to-date percent change in bid prices of long-dated Austrian debt benchmarks
70-YEAR BOND
50 %
40
30
20
10
0
-10
February
March
April
May
June
July
August
100-YEAR BOND
80 %
60
40
20
0
-20
February
March
April
May
June
July
August
Source: Refinitiv Datastream
Ritvik Carvalho | REUTERS GRAPHICS

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GLOBAL OUTLOOK, THE INVERTED YIELD CURVE AND FISCAL STIMULUS

While global earnings have been roughly inline with downgraded expectations, they are still being downgraded overall as the year progresses. Notably, the US remains robust off last years high base which should continue its relative outperformance from and equity market point of view.

The inversion of the yield curve in the US in itself is not a guarantee of an imminent recession but is highly predictive and also influenced by future expectations and the flow of money. Most regions globally are seeing lower growth outlooks, the impact of monetary stimulus is not expected to be long lasted.

We are concerned that as the trade war drags on that it will knock on to US investor and consumer confidence which has been strong thus far. This will lead to a destocking cycle which will accelerate the likelihood of a global recession or at least a meaningful slowdown. We have moved into a world that is dependent once again on Central Bank and Government intervention as positive economic data points are not always seen favorably.

The global economy is at the point where fiscal stimulus out of Europe and China is needed to provide some meaningful impact to change the current growth outlook. Europe's ability to do this is complicated but Germany is moving closer to this point and we expect more stimulus out of China.

The flow of money – investment impact

The implication of this incredibly low-yield environment is sustained demand for US Treasury's, bond-like equities, equities exhibiting secular growth profiles, and the carry trade (which should support high-yield bonds like South Africa where the yield spread is still in the region of 6%). Unfortunately, all of these have become a very crowded space and thus carries with it significant risk as well.

Risk outliers

The outlier in the global geopolitical landscape is a blow-up in the Iran situation which has been threatening to boil over. This has the potential to escalate quite quickly and remains an outlier on the risk front that is underappreciated.

Stock market now negatively correlated to economic surprises

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SOUTH AFRICA

We have sought to make a bull case for SA domestics with the view being that most of these companies have been cutting cost and maximising operational efficiencies for the past 5 years or so as the economy has been grinding along.

This view has been apparent from the earnings we have seen thus far, characterised by excellent cost management. However, a number of companies are running out of cost-saving levers and are moving towards a negative jaws paradigm. The continuous downgrading of the growth outlook means that earnings will remain under pressure and as such the forward earnings multiple many use as a benchmark is perhaps not as cheap as it appeared at the start of the year.

The ZAR appears to be undervalued at current levels of R15.2/USD with some houses ranking the fair value on a PPP basis as strong at R11/USD. Clearly the risk of a downgrade remains very real and is being priced into the currency at current levels and will remain a risk until there is a suitable action plan around Eskom. The hidden cost of the ongoing downgrade risk is the investment uncertainty and low confidence levels that consequently arise. This lack of confidence and certainty is one of the biggest hindrances to SA's economic turnaround as corporate money continues to sit on the side-lines.

As the global economy falters it is critical that we see some action out of government.

Some government initiatives that could have meaningful positive impact on sentiment and the economy are as follows:

- Concrete action plan to deal with Eskom debt and streamline SOEs
- Genuine action against high profile corruption
- Targeted Special Economic Zones
- Immediate Mining Charter resolution and revival of the stagnant mining sector
- Conclusion of the spectrum auction

The opportunity to kick start the economy does exist. There is a lot of dry powder both locally and offshore desperately looking for a reason to invest or spend in SA and we are keeping a close eye for signs of change.

Positioning

In the face of the many headwinds both globally and locally our positioning remains fairly cautious. Miners are late cycle and barring fiscal stimulus out of China, the commodity cycle (including PGMs) is at risk of a meaningful slowdown. We have a strong bias towards high quality counters with a defensive quality and limited earnings uncertainty/cyclicality. This includes Rand hedges and secular growth stocks. Where quality stocks are oversold in the extreme negativity, we see opportunity to build positions, for example in the bank and insurance sector.

The apparent value in a number of large and mid-cap industrial stocks will not be unlocked until the outlook improves and we are largely avoiding this sector.

Discretionary retail also falls into the value-trap category and we favour food retail as food inflation begins to entrench itself.

We are also extremely wary of the SA property sector which has not yet reflected the global reality of changes in consumer behaviour.

CONCLUSION

Given the macro-economic and political backdrop, we expect the elevated levels of volatility to remain both globally and in SA. As such, ECM is cautiously positioned into H2 while looking for targeted and tactical opportunities around this cautious base as and when they present themselves.

Special Feature: Consumer Robotics

At ECM we look for structural long-term growth opportunities. The robotics industry is growing at a rapid pace and is moving beyond the traditional industrial automation format. The total industry size is expected to reach $93bn by 2023. The application of robotics is expanding to industries such as military, construction, medical (such as surgical robots) and agriculture. The rapid adoption and efficacy has been aided by the advent of AI and mechanical advancements.

Consumer robotics

The ageing and wealthy population in Japan, Europe, and America coupled with rising labour costs and shortages in some cases has given rise to a shortage of healthcare providers to the aged. This is fertile for innovative robot assistance which is growing at a rapid rate. Robots are able to take vital statistics, provide assisted walking, administer medicine and more.

As we accelerate the rate of AI and materials science robotics evolution, this trend is going to grow. This materials science has allowed for robots providing interactive body assistance which can pick up and put down people gently and is covered in a soft 'skin'. As the global population continues to age the market for caretaking robots, robotic limbs and more will expand rapidly.

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