ClucasGray Private Clients

Quarterly Commentary

September 2019

"I skate to where the puck is going, not where it has been." Wayne Gretzky

In the midst of the euphoria following the Cyril Ramaphosa victory at the ANC elective conference in December 2017, we came across the following quote from a prominent Cape Town real estate agent in the FinWeek:

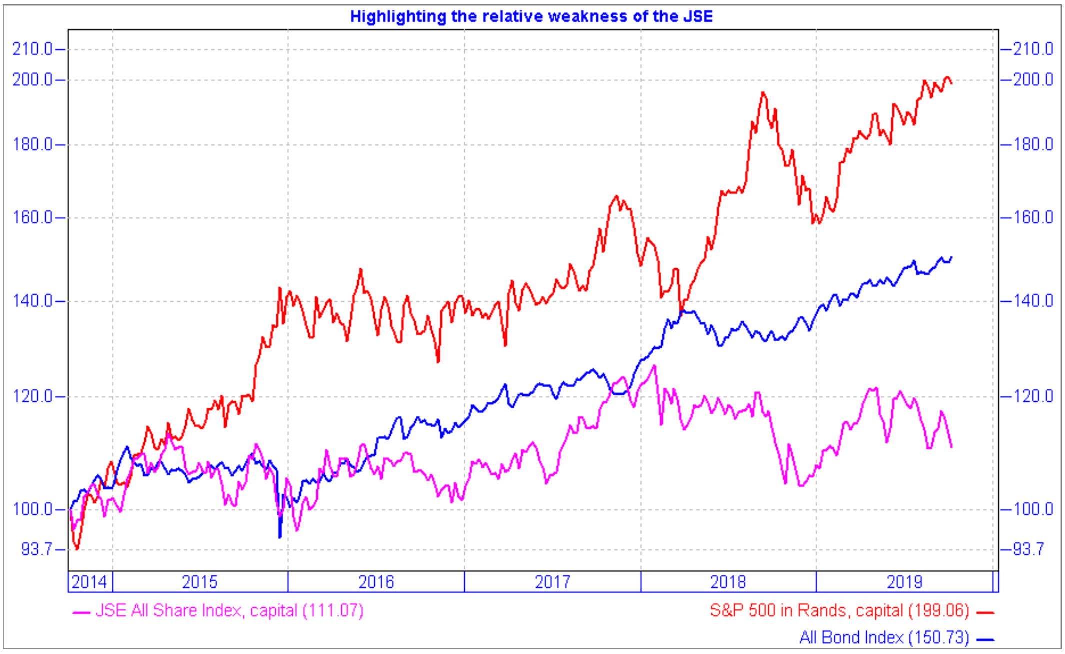
"Given the phenomenal price growth on the Atlantic Seaboard, you really cannot go wrong with an investment here."

The quote is not intended in any way to discredit anyone - there is not a professional investor alive who has made claims or predictions that may not have come to pass, and the subsequent move in property prices is irrelevant to us. The point for us is that the quote highlights one of the most dangerous themes in investing – the argument that assets that have already gone up appear good investments, and the converse – assets that have already fallen in value, are best avoided. We don't subscribe to any styles when it comes to our philosophy around investing, but the above approach could perhaps be best described as momentum investing – what has transpired will continue to transpire, until it doesn't!

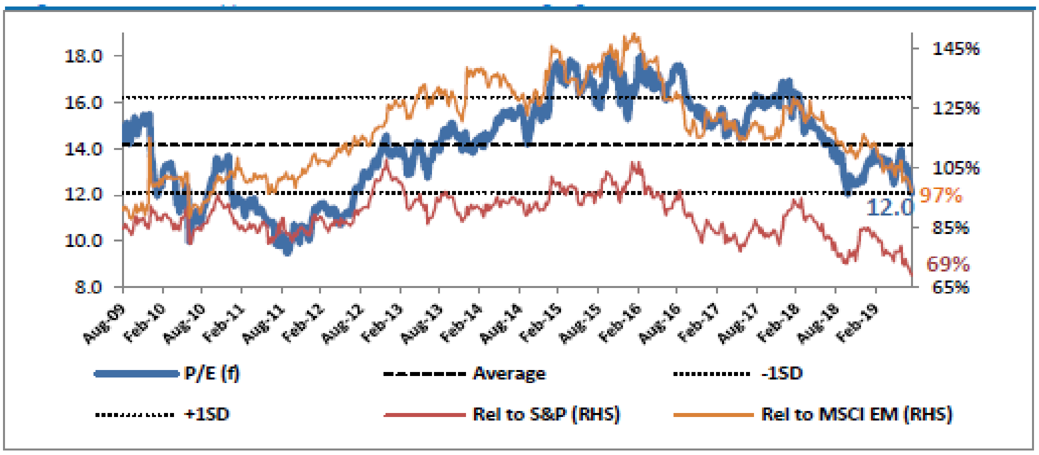
South African equity investors must be, justifiably, weary of hearing about the local equity opportunity set. As shown in the chart below, the rolling 5 year capital returns on the JSE are now worse than at any point since the 1970's - a 40 year period that has been characterized by numerous global and domestic crises, political and economic alike. Investors have every right to be disillusioned with local equity.

The investment landscape has been characterized by the relative outperformance of US Equity (in Rands) and Fixed Income assets over local equity.

The chart below highlights the extreme divergence in these 3 major asset classes over the last 5 years. Notwithstanding fears around credit rating downgrades, an apparent lack of a plan to deal with over indebted and loss making State Owned Entities, a sustained weakness in the Rand and a crisis in confidence, South African bond yields have remained resilient, and given our extremely elevated interest rates, fixed income investors have enjoyed attractive returns. Ironically, many of the issues mentioned above, are the same fears attributed to the weakness in the local equity markets.



There appears an increasing desire amongst investors to continue to gain exposure to fixed income assets and offshore equity, all at the expense of the local equity market. We comment more fully on yields and income assets later in this note, but we think that the chart below is worth reflecting on. Arguably for good reason, the SA market looks cheap relative to its own history (blue line), broader emerging markets (yellow line) and at extreme levels against the likes of the S&P 500 (red line) – highlighting just how well US Equity has already performed.



Source: Bloomberg, Investec Securities estimates

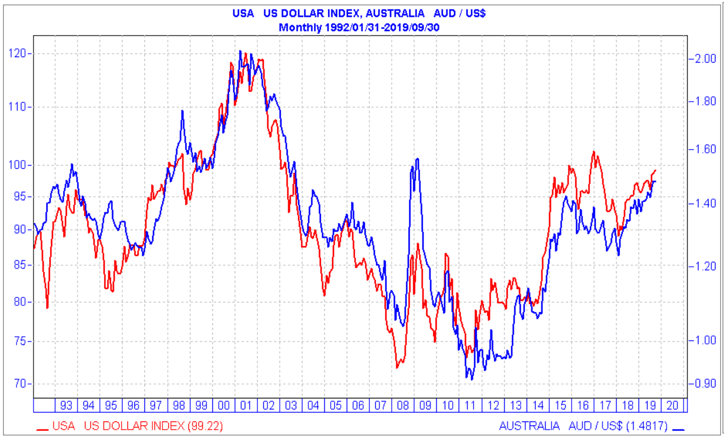
In the words of Wayne Gretzky above, we think it is appropriate to strive to skate where the "puck is going, not where it has been"!

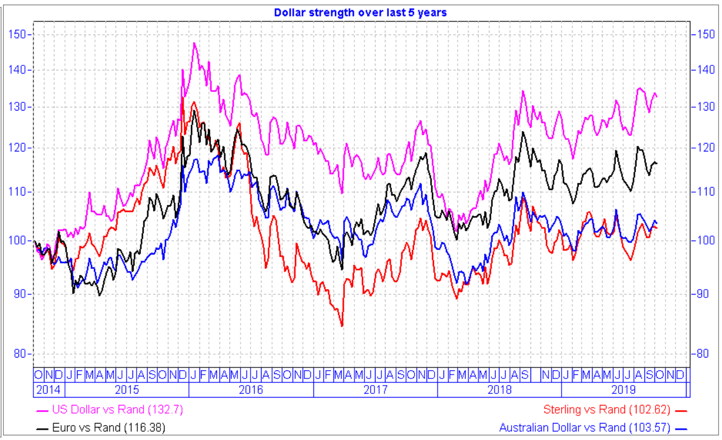
Investment Overview

The ClucasGray investment process strives to objectively assess every investment case on its relevant fundamentals. We are not by nature contrarian, but we are certainly prepared to adopt contrarian views when our conviction dictates. Given the ability to invest across asset classes and regions, we strive to deliver consistent inflation beating returns to investors, through a combination of active asset allocation and security selection.

Discussions, social and professional, about the Rand and the outlook for our beleaguered currency are typically emotive. What is perhaps overlooked in the debate around South Africa, is that the Rand has performed in line with many other currencies, including both the British Pound and the Australian Dollar over the last 5 years (see below chart on right).

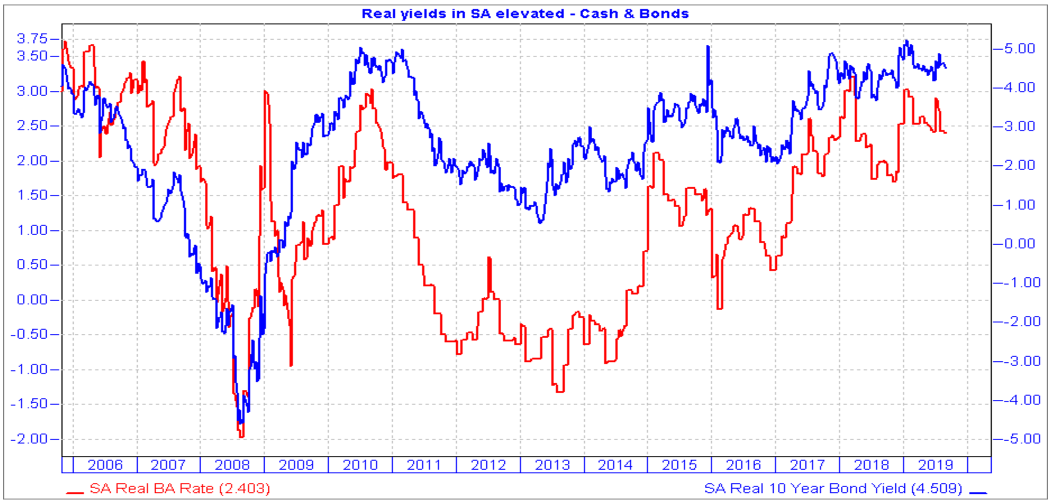
As the two charts below depict, Dollar strength has been the stand out theme over the last number of years. The chart on the left shows the US Dollar index and the US Dollar relative to the Australian Dollar. For much of the last decade, the US Dollar has strengthened against all major currencies – it has enjoyed the benefits of relatively stronger economic growth, relatively higher interest rates, and the real valuation moving from inexpensive to expensive. There is growing evidence that all three of these factors may start to work against the Dollar. The outlook for the Rand may well be determined by global factors way beyond the control of South African policy makers. What is increasingly undeniable, is that the real valuation of the Rand is cheap – whether it trades anywhere near it's fair value in the near term remains the key debate.





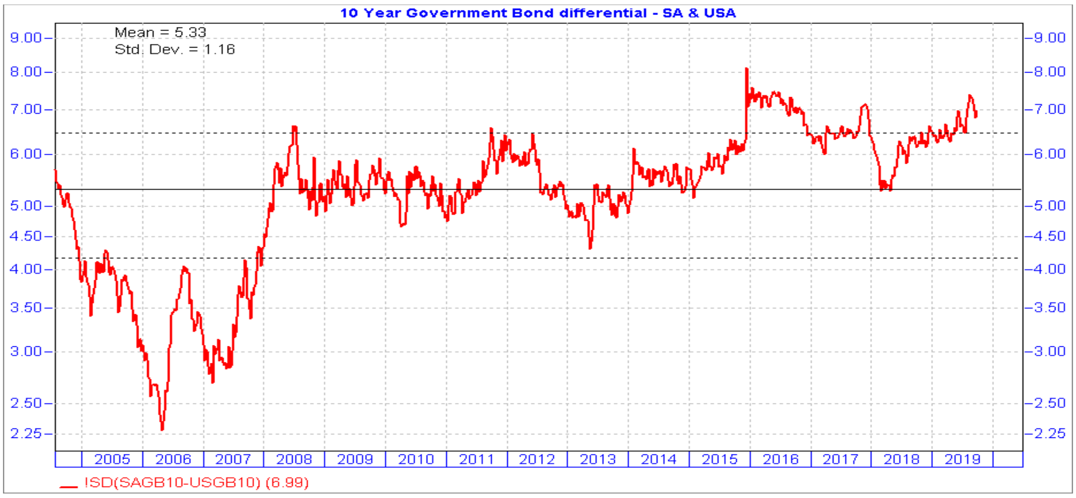
Given elevated interest rates in South Africa, investors are able to lock in real yields of between 2.5% and 4.5% depending on the level of duration they are prepared to accept (see chart below). This undoubtedly holds appeal, but we must stress that this situation has been in existence for an extended period.

As the saying goes, "one person's bread, is another's poison". Savers have been significant beneficiaries of these elevated yields, at the expense of the consumers, who have been forced to endure interest rates higher than warranted by the weakness in the economy. In a world with $16 trillion of negative yielding bonds, the luxury of high real and nominal interest rates is unique to South African investors.

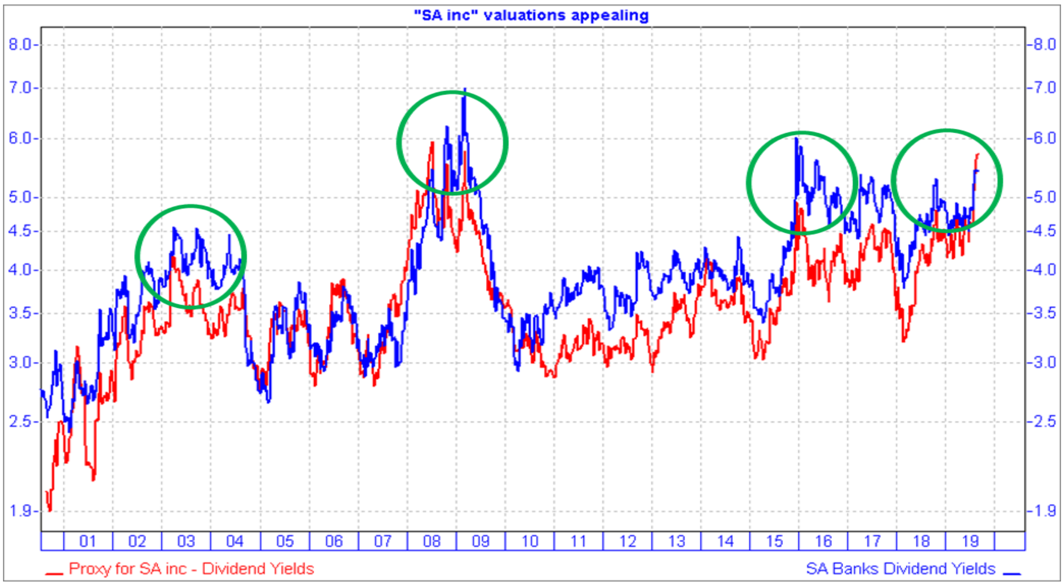


The yield differential between South African and US 10 year government bonds is equally instructive. As shown in the chart below, it has seldom been higher, stubbornly elevated at "Nenegate" levels from December 2015 - in our view this more than compensates investors for the perceived risks in local bonds.

Taking this argument one step further, for investors to be better off in global income assets than in local income assets, the Rand needs to depreciate significantly to offset the elevated yield differentials on offer in South Africa.



As regards local equities, the JSE is optically cheap – valuations have seldom been more attractive. The chart below is an updated version of one we have shown before – the dividend yields of the bank index in blue, and an average of 7 large financial and industrial companies in red. It is true that yields have been higher, but only at the height of the global financial crisis in 2008/09. It also shows how protracted this period of undervaluation has been – hence we completely understand the weariness with which some may greet any discussion around the compelling opportunity set!



Conclusion

Notwithstanding the uncertainty around the prospects for companies to grow their earnings bases in a difficult economy, we take comfort in current valuations. We have been presented with the opportunity to invest in numerous cash generative companies, with appropriately geared balance sheets, at inexpensive valuations. We have no insight as to when the economy improves, or when the magic of earnings growth starts to contribute to equity returns, but we do believe that by the time we have more certainty, the valuation gap may well have closed. In the words of Tolstoy, which in our view are apt for the local equity market:

"The two most powerful warriors are patience and time."

Kind Regards

The ClucasGray Team

CLUCASGRAY

Annexure: Return Table – 30 September 2019

ClucasGray Summary: Source Bloomberg							
Data to:		2019-09-30					
DOMESTIC MARKET	SPOT	1 Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share TR	8277,0	0,19	-4,57	7,08	1,86	5,07	5,32
JSE CAPPED SWIX TR	21 898	0,67	-5,11	1,40	-2,44	1,05	3,36
JSE MID CAP INDEX	69 380	-0,83	-2,73	-0,67	1,27	-3,39	1,47
JSE Resi TR	2 974	-0,48	-7,33	10,46	4,94	14,54	-0,01
JSE Fini TR	9 158	3,46	-7,67	-1,62	-1,97	6,59	6,27
JSE Indi TR	13 788	-0,92	-2,28	11,06	3,47	2,67	5,75
Property TR	1 866	0,30	-4,44	1,34	-2,70	-3,51	3,24

GLOBAL MARKETS (Local Currency)		Month	Quarter	YTD	1Y	3Y	5Y
MSCI All Country WORLD INDEX TR	259	2,10	-0,03	16,20	1,38	9,71	6,65
S&P 500	6 009	1,87	1,70	20,55	4,25	13,39	10,84
Nasdaq	7 999	0,46	-0,09	20,56	-0,58	14,62	12,23
Euro Stoxx 50	7 560	4,25	3,04	21,92	7,94	8,77	4,81
Shanghai	2 905	0,66	-2,47	16,49	2,97	-1,12	4,21
FTSE 100	6 798	2,97	0,98	14,25	3,23	6,79	6,47
MSCI Emerging	472	1,91	-4,25	5,89	-2,02	5,97	2,33

Exchange Rates		Month	Quarter	YTD	1Y	3Y	5Y
ZAR/$	15,14	0,39	-7,45	-5,50	-3,05	-0,91	-7,25
ZAR/£	18,61	-0,78	-4,08	-1,59	2,21	1,29	-1,00
ZAR/€	16,50	1,13	-2,96	-0,23	3,20	-0,12	-3,32
ZAR/AUS $	10,22	0,10	-3,34	-0,93	3,27	2,65	-0,51
ZAR/BRL	3,64	0,55	0,47	1,68	-0,54	7,25	5,22
$/£	1,23	-1,09	3,21	3,65	5,18	2,20	5,83
$/€	1,09	0,76	4,17	4,95	6,06	0,78	3,66
$/CHF	1,00	0,77	2,18	1,63	2,91	0,47	1,65

COMMODITY PRICES		Month	Quarter	YTD	1Y	3Y	5Y
Oil (Brent)	59,3	1,35	-7,13	7,45	-19,95	2,30	-9,18
Copper (3 month LME)	5 725,0	1,29	-4,47	-4,02	-4,18	7,43	-3,89
Platinum	883,2	-5,40	5,79	11,00	12,15	-5,67	-9,11
Iron Ore	93,0	5,94	-17,45	31,74	49,99	17,51	1,53

Bond Prices	2019-09-30	2019-08-30	2019-06-28	2018-09-28	2016-09-30	2014-09-30
RSA 10 YEAR	8,32	8,21	8,08	8,99	8,66	8,32
US 10 Year	1,66	1,50	2,01	3,06	1,59	2,49
German 10 Year	-0,57	-0,70	-0,33	0,47	-0,12	0,95
UK 10 Year	0,49	0,48	0,83	1,57	0,75	2,43