# ClucasGray Private Clients

## 3rd Quarter Commentary

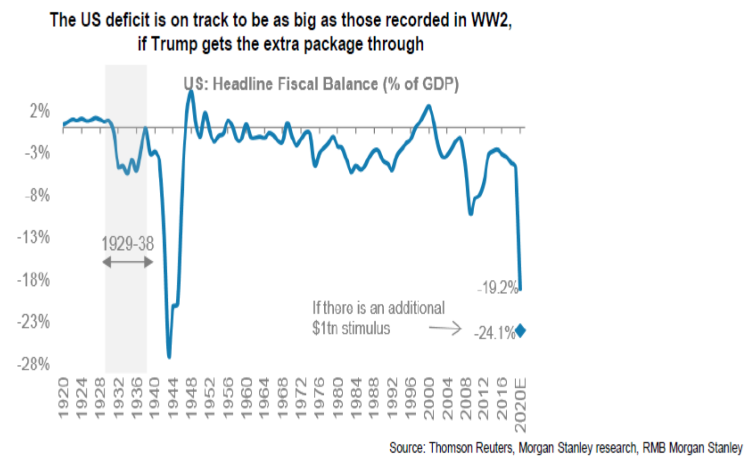
August 2020

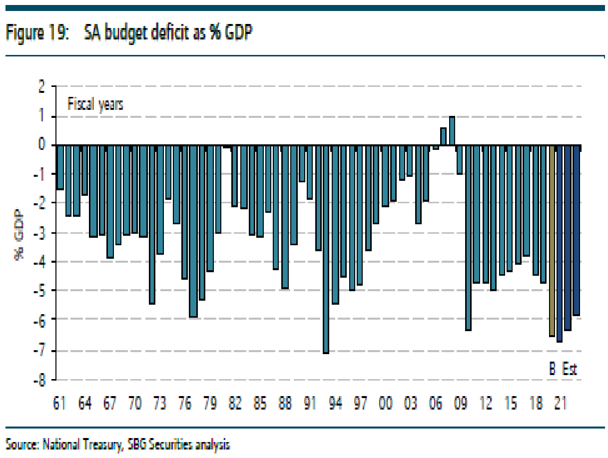
*"I frequently get asked the question: "what's going to change in the next 10 years". I seldom get asked "what's not going to change in the next 10 years."" Jeff Bezos, Amazon*

## 2020 – Remarkable Start to the Decade

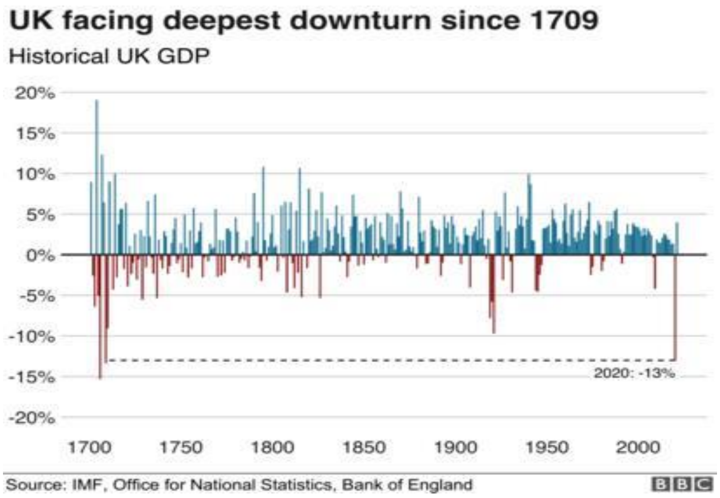
It is nearly 5 months since South Africa emulated major global economies, and embarked on its policy of national lockdown. Strong, emotive and divergent views on the strategy of lockdown permeate global society – lives have tragically been lost to the virus, livelihoods have sadly been impaired. "Lives versus Livelihoods" - a debate that will rage on for years to come.

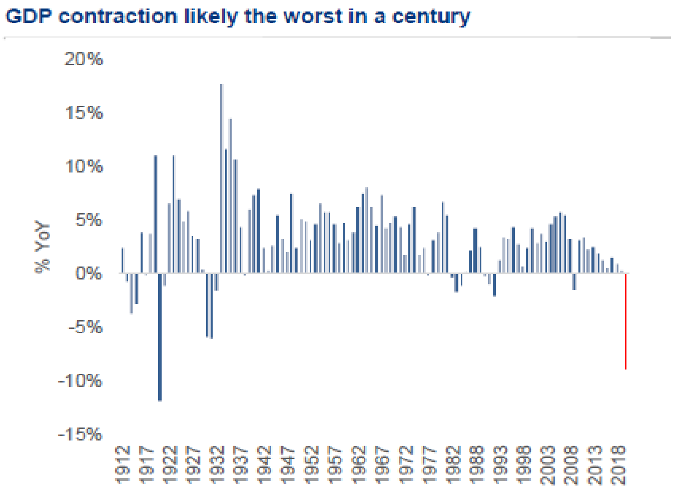
Much has been written about the economic devastation caused by the Covid crisis, and the lockdowns. The chart on the left below, is we believe pretty startling - it shows the US fiscal deficit as a percentage of GDP, with 2020 forecast to have the largest deficit since World War 2! On the right, is the South African budget deficit – much like the US, the next few years will see our deficit grow, putting strain on government finances.




The UK GDP is predicted to have the sharpest fall since the Thames froze over in the Great Frost of 1711 – 309 years ago (chart below left)! As shown by Standard Bank on the right below, South African too is about to experience its worst contraction in GDP in a hundred years!




Source: Standard Bank

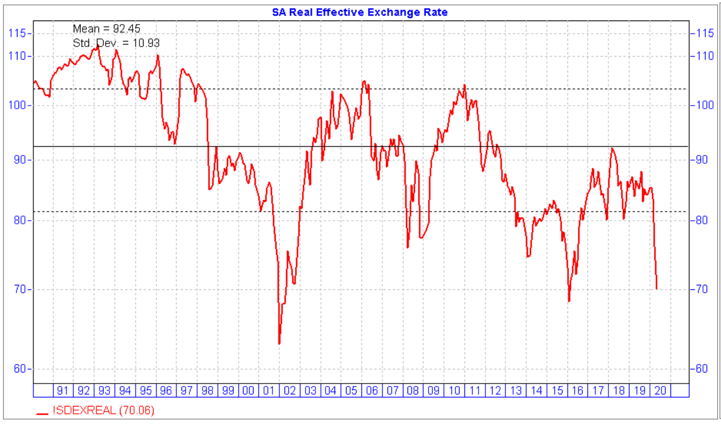
To simplify, if possible, the conundrum facing investors today - we are experiencing the most severe economic downturn in living memory, which has been met with the most aggressive fiscal and monetary policy response in history. The implications thereof for asset prices is complex, more so given the seismic downward adjustments in the price of many assets over the last few months.

Many equity markets including the JSE have recovered substantially from their March lows, seemingly at odds with the severity of the economic downturn and hardship at a household level. The forward-looking nature of markets combined with the enormous global policy responses, have led to the shortest bear market on record.

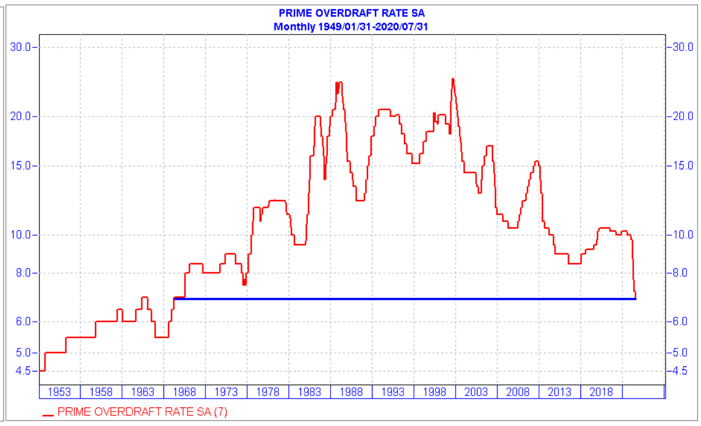
## South African Environment

In the wake of the Covid crisis, the global investment landscape has been dominated by high level macro debates. Of particular relevance to South Africa, much of the debate has revolved around the ability (or lack thereof) of emerging economies like South Africa to weather this unprecedented storm. As is widely reported, South Africans are grappling with multiple complex issues – unsustainable levels of government debt; a narrowing tax base; lack of economic growth, and opaque prospects for this to improve; rising unemployment, amplified by the Covid crisis; allegations of corruption and seemingly a culture of impunity; a crisis of business and consumer confidence; and a Rand that has been in structural decline for much of the last decade. Whilst the issues of the day may be unique, there is a certainly a familiarity about their tone.

The real effective exchange rate (chart below left) is currently as weak as it has been only 3 times in the last 30 years – 2001, 2015 and 2020. Any view on the prospects for the South African economy, the currency, and investment opportunities requires a view on the global backdrop. We note continuing signs of increasing economic activity from key global regions, talk of large scale infrastructure investment to drive the post Covid recovery, and what appears once more to be an insatiable demand for key industrial commodities from the likes of China. The strength of underlying commodity prices has been instructive – not only for the Resource heavy JSE, which has benefited from rising share prices, but more as an indication of improving global activity. Whilst the shape and speed of the global recovery is up for debate, we are seeing encouraging signs of improvement.




Source: Iress, ClucasGray




Source: Iress, ClucasGray

The importance of the commodity cycle for South African investors is not isolated to resource companies. Very few, if any, commodity cycles in history, have not resulted in an improvement in economic activity in emerging markets like South Africa – rising GDP, a stabilisation of currencies, moderation in inflation, and lower interest rates. Every cycle is unique, and there are justifiable concerns around the numerous complex issues facing South Africa today.

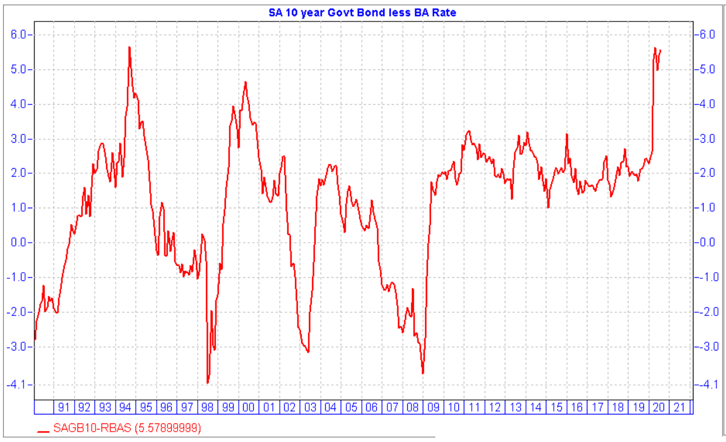
It is a never ending debate, and one that is yet again raging in the investment industry – consensus thinking is that South Africa is better off with a weaker currency. The counter argument is that the scale of the consumer related economy and the benefit accruing to it from lower interest rates, is a powerful economic force. It is a force that has assisted the recovery in numerous previous cycles. The quantum of interest rate reductions this cycle is significant (chart above right) – as significant as any previous interest rate cutting cycle, including the early 2000's, with interest rates now as low as they were in the 1960's. At some stage, lower rates should help, unless of course this time is indeed different.

The scars from the Covid crisis are likely to run deep, and the confusing rhetoric emanating from those in power has not done much for confidence. However, the key to our recovery from the depths of 1998, 2001, 2009 and 2015 crises had little to do with the local policy backdrop – each coincided with a global economic recovery and robust commodity cycle. With the strength of many industrial commodity prices, and early signs of an economic recovery globally, it is not inconceivable that yet again, a constructive global backdrop could lead to a stabilising of EM currencies and the Rand, and with it, all the ancillary benefits we have seen in prior cycles.

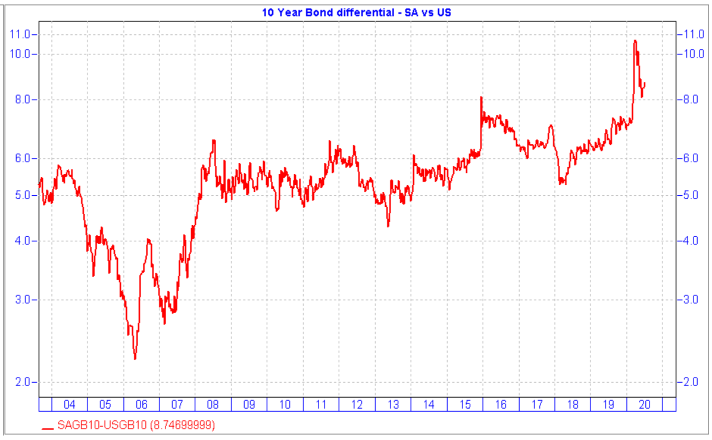
## South African Fixed Income

Having endured a tough March and April, bonds recovered strongly, with the South African 10 year bond yield falling from a peak of over 12% in March to around 9.2% today. It is well documented that the South African fiscal position remains tenuous, and this has resulted in sustained periods of elevated yields – the strange thing about investing is the counter balance that exists between the narrative around a company or asset class, and the valuation thereof.

Excluding the obvious benefit of hindsight, it is exceedingly rare to discover attractive valuations, with reasonable prospects. The allure of South African 10 year government bonds is self-evident – a cursory glance at either the real yields or the yields relative to the US 10 year bond illustrates the extent of the opportunity. The counterbalance is clearly the perception of the ability of South Africa to meet the interest obligations on the ever-increasing debt. The steepening of the yield curve is to us extremely instructive – the market has growing concerns around the government's longer-term credit worthiness – the compensation for these concerns are amongst the most enticing longer duration yields on offer globally. The chart on the left below highlights the yield gap between the 10 year bond and cash rates – unparalleled in decades. The chart on the right below is the 10 year yield gap between South Africa and the US – nearly 9% higher yield here in South Africa, the clearest indication that the South African narrative is currently extremely poor!




Source: Iress, ClucasGray




Source: Iress, ClucasGray

## South African Equities

The ClucasGray equity investment process is principally founded on the belief that by investing in companies that can deliver real growth in earnings, and paying an appropriate valuation multiple for that earnings stream, is the best was to compound returns over time. For South African investors, the last few years seem to have been at odds with the above, given that valuations have for some time been compelling for a more normal operating environment – the environment has unfortunately been far from normal.

Clearly the events of the last few months have proved tough for many businesses, both globally and here in South Africa – what were already subdued earnings bases in 2019, are going to prove virtually impossible to match in 2020. The equity market appeared to price in much of the economic damage from the strategy of global lockdowns almost immediately, and whilst the news flow around company earnings is currently poor, one has to reflect on whether this has already been more than priced in.

We think the chart below is particularly instructive – it shows that the forward PE of the JSE, stripping out Naspers, has de-rated back to 2003 and 2009 levels. Most investors agree, with the benefit of hindsight, that in both of these prior periods the market was too cheap. In addition, the JSE is now at the largest discount to the Emerging Markets index on record.

**Figure 15: MSCI SA ex Naspers vs MSCI EM 12m fwd P/E ratio**


Source: MSCI, FactSet, SBG Securities analysis

We expect global GDP to recover off the 2020 lows, and notwithstanding the myriad issues facing South Africa, we also expect SA GDP to rise towards the 2019 levels over the next few years. With this backdrop, the earnings of many companies are likely to recover towards their 2019 levels by 2022 – in numerous instances, the valuation multiples on these more "normal" earnings appear very attractive. Forecast risk in the nearer term is high, but if our base case is broadly correct, the potential exists for out sized returns in many holdings from current levels.

The JSE is diverse, and its performance so far in 2020 is in many ways at odds with the economic reality. Certain key sectors, most notably the Internet and Gold sectors, have been material beneficiaries of the Covid crisis. It is well documented how well the Nasdaq has performed, and Naspers and Prosus too have benefited from the performance of their key holding, Tencent. Gold is typically a beneficiary of any crisis, and with this crisis being one of the largest on record, a minor frenzy has seemingly developed around the investment merits of the metal - the JSE Gold Index is up over 100% since the beginning of the year. The combination of Naspers and Prosus, and Gold currently makes up nearly 25% of the Capped Swix, and 40% of the JSE Swix, and as a result have provided an enormous boost to the JSE.

The nature and extent of the crisis has required us to ask questions about whether some businesses have been temporarily or permanently impaired. For some businesses, the temporary shock may prove to be fatal - a longer term change in consumer behavior, product relevance, too much debt could all be possible reasons. However for other businesses, the shock may prove to be just that - temporary in nature and therefore a good opportunity for long-term investors. Our sense is that given the lopsided nature of the recovery, the forward-looking opportunity set may also be lopsided. There are businesses in underperforming sectors that are of high quality, well managed, and with strong balance sheets. We believe that they will recover, as will their share prices.

As alluded to earlier, there are many reasons to remain cautious around the ability of South Africa to navigate its way through this crisis. However, we are mindful of the fact that we have survived many crises over the years. The possibility exists that "this time is different" - traditionally dangerous words to use in investing, but these are extraordinary times. It is worth noting that opportunities have never presented themselves in periods when the narrative was good. We have no insight into when the environment improves, but using history as a guide, and with valuations as undemanding as we can recall, we believe now would not be the appropriate time to give up on South African equities.

## Domestic Asset Allocation

The current reality, as a result of the crisis, is that South African investors have been presented with an attractive opportunity set, with the longer duration bonds and domestically focused equities trading at yields and valuations deemed unfathomable barely 6 months ago.

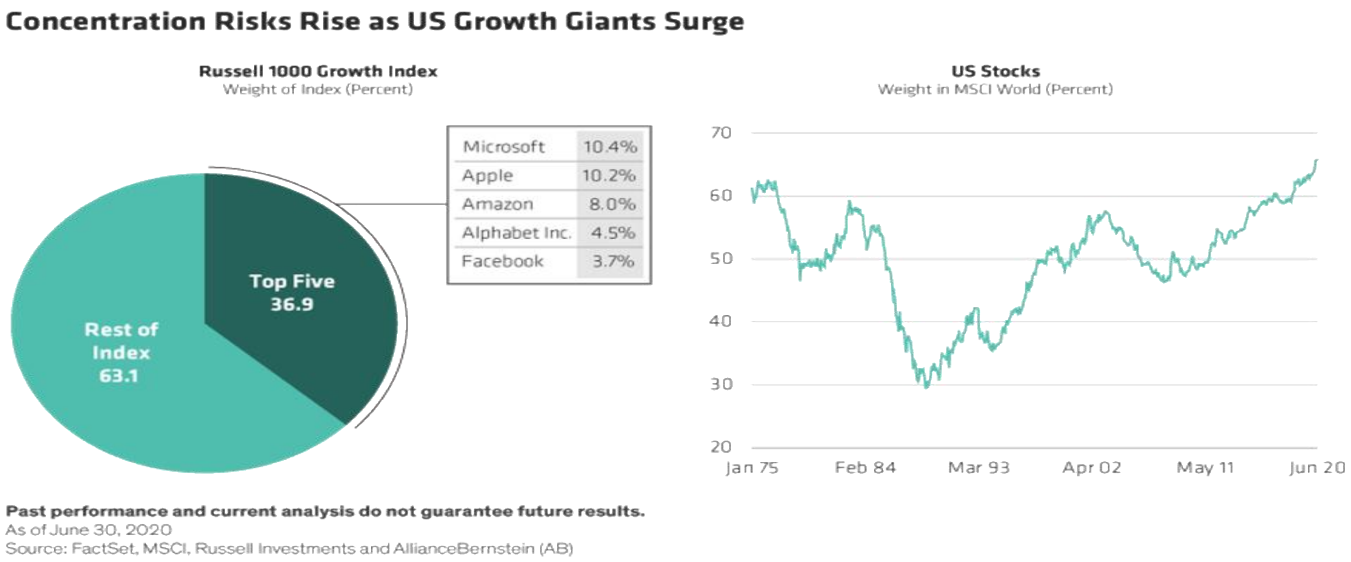
Very long duration bond yields are indeed enticing, and the temptation exists to have exposure to these assets. Given the inter relationship of bond yields and equity valuations, the potential exists for outsized returns in many parts of the equity market were bond yields to moderate, we have preferred equities to longer duration bonds.

We are mindful of the risks that abound – as mentioned earlier, the natural tension that exists between the narrative of an asset class and its valuation has seldom been better illustrated. In the case of local equities and bonds, the narrative is poor, the valuation appeals. Conversely, in the case of US Equities, global technology or gold, the narrative potentially reads well, the near term investment case in our view, less compelling.

## Global Perspective

The recovery in global markets is encouraging at an aggregate level, however it belies the lopsided composition of the sector and company specific returns. Indeed, the most notable feature of the recovery in global markets is the concentration of performance from a narrow set of companies – in simple terms too few companies have driven the market recovery. This is no better illustrated than in the chart and table below (Chart from Alliance Bernstein). Due to their phenomenal performance, five companies now make up over a third of the Russel 1000 Growth Index and US stocks now comprise two thirds of the MSCI World Index.

There is no denying that many of these businesses deserve to have performed as they have – their business models have either been direct beneficiaries of the lockdowns or already sound business models have been further reinforced.




The key challenge in navigating the current global landscape is that non-equity markets remain unappealing, and equity markets at an aggregate level (and more specifically the US markets) are not cheap. Even accounting for a strong earnings recovery into 2021 / 2022, US valuations are high by historic measures.

To further illustrate the point, we find the table below particularly instructive – it breaks down the year to date performance of the S&P500 (up to 31 July 2020). This highlights a few key issues. Whilst the index has delivered a positive return year to date, in the face of the most significant halt to global economic activity on record, it is the performance of the larger cap, mostly technology, shares that has astounded many. The table below shows how the top 50 shares have delivered positive returns, whilst the other 450 shares have on average declined. More noteworthy is that the disparate valuation metrics – the gap between larger cap technology shares and the rest of the index constituents appears extreme.

| S&P 500 (31 July 2020) | Market Cap | YTD TR | P/E | P/FCF | P/B |
|---|---|---|---|---|---|
| Top 5 | 1,551.4 | 30.7% | 34.1 | 34.5 | 13.1 |
| Top 10 | 599.2 | 10.5% | 33.2 | 32.6 | 9.4 |
| Top 50 | 202.7 | 3.8% | 26.3 | 23.2 | 5.8 |
| 51-100 | 80.1 | -1.8% | 22.9 | 25.8 | 5.8 |
| 101-150 | 51.9 | 1.8% | 23.4 | 24.0 | 3.9 |
| 151-200 | 31.7 | -0.8% | 24.4 | 20.5 | 4.7 |
| 201-250 | 25.4 | -3.5% | 22.7 | 21.6 | 3.4 |
| 251-300 | 20.7 | -0.7% | 24.7 | 22.3 | 3.2 |
| 301-350 | 15.2 | -7.0% | 25.4 | 22.2 | 2.4 |
| 351-400 | 12.5 | -13.7% | 21.2 | 18.9 | 2.9 |
| 401-450 | 9.3 | -19.9% | 14.6 | 13.0 | 2.0 |
| 451-501 | 5.1 | -39.3% | 14.7 | 10.3 | 1.1 |

**Source: ClucasGray; Bloomberg** (Note: YTD TR = Year to Date Total Return; P/E = Trailing Price Earnings; P/ FCF = Price to Free Cash Flow; P/B = Price to Book)

Whilst risks to earnings remain elevated, some sectors and areas of the market appear to have adjusted for the uncertain economic outlook, others have arguably not, and are expensive by any measure. The result of this lopsided performance is that the valuation and opportunity set looks better in specific regions and the sectors and companies within them, Select markets, such as Europe, Asia and emerging markets also look more attractively priced relative to the US and still appear to offer long-term value

We continue to interrogate and weigh the appropriate level of global diversification within client portfolio's, being cognisant of the investment opportunities as well as the mandate pertaining to individual circumstances and requirements.

## Conclusion

There is justifiably little conviction on how the post Covid economy evolves. Whilst there are numerous unique characteristics of this crisis, the future has always been difficult to predict, as alluded to by Jeff Bezos in the earlier quote. It is for this reason that one of the cornerstones of our investment process is valuation – in periods of uncertainty, one has often been able to take comfort in valuations – we don't believe there is much optimism currently reflected in the valuation of many domestic assets. Specific regions and sectors within global markets also look reasonably priced with a medium to long term view.

The backdrop of an improving global economy, record levels of stimulus and rising commodity prices would typically be a constructive one for emerging markets, and South Africa. Coupled with one of the most aggressive reductions in South African interest rates on record, it is not inconceivable that the next few years could see a recovery in domestic demand – given current valuations the net effect may prove rewarding for investors.

If there is any interest to engage further, please don't hesitate to get in touch with us.

Kind Regards

The ClucasGray Team