ClucasGray | Quarterly Commentary

March 2022

Russia's invasion of Ukraine on the 24th February and the subsequent scenes that have unfolded over the last six weeks have been disturbing to witness. The humanitarian consequences are dire, and our thoughts are with the individuals and families who have been directly impacted by the crisis.

The coordinated response to the crisis in the form of Western sanctions together with the exit or write-downs of numerous global multi-national company operations in Russia is unprecedented and the medium term economic consequences for the country are likely to be harsh. We don't have any particular insights as to what geopolitical developments may transpire next, but can only hope that a peaceful resolution to the conflict can be found urgently.

The global investment landscape is complicated presently and we have set out some of the key investment issues which we are debating internally, as well as our response to managing portfolios in this environment.

Risks To Global Growth Are Building:

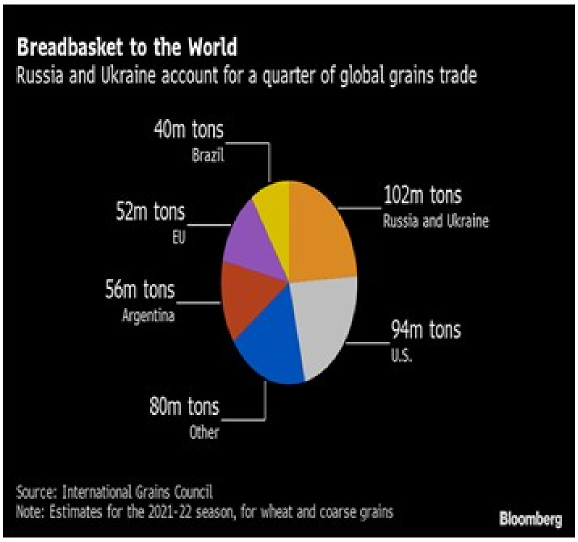
The Russian Invasion has exacerbated a number of macroeconomic factors which were already prevalent; building inflationary pressures, supply-side constraints and the prospect of rising interest rates in key developed economies.

One of the central risks to global growth is evolving in the energy and commodity markets where Russia and Ukraine account for a significant share of specific energy, industrial and agricultural commodities. The notable point (highlighted in the table below) is that the extent of supply that is exported is meaningful, with obvious potential implications for the global supply of these individual commodities.

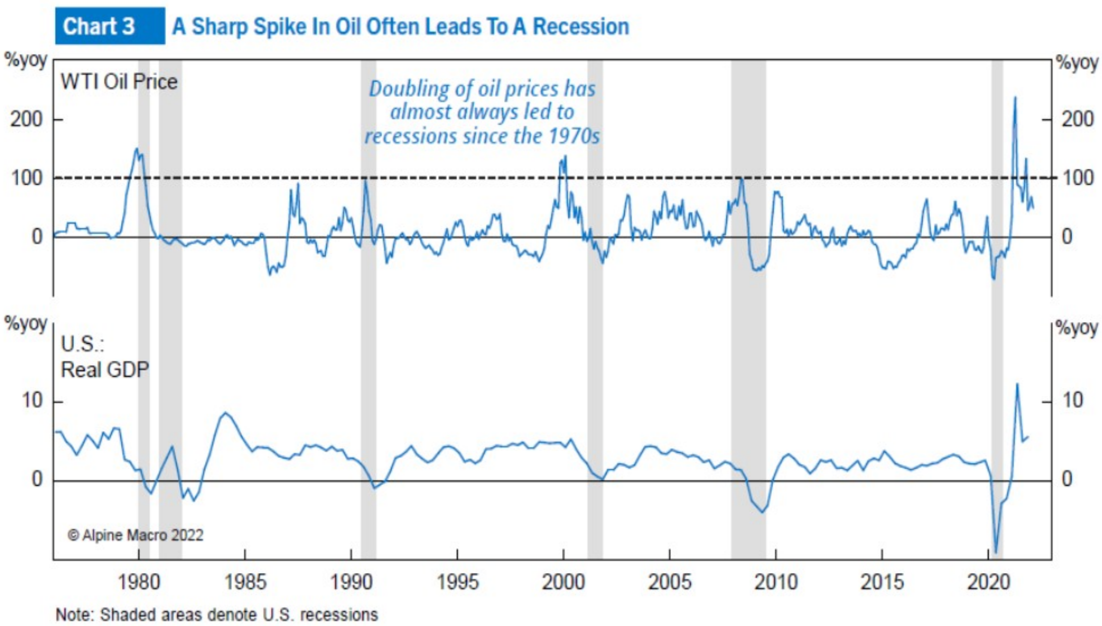
Potentially dramatic losses of Russian supply

	Annual Russian output	Share of global supply	Of which rough exports
Crude Oil (Mbd)	10.2	10%	45%
Natural Gas (BCM)	760	19%	26%
Aluminium (kt)	4,200	6%	80%
Copper (kt)	1,000	4%	75%
Nickel (kt)	225	8%	90%
Palladium (koz)	2,700	27%	95%
Platinum (koz)	750	11%	95%
Iron Ore (Mt)*	100	2%	25%
Met coal (Mt)*	74	9%	39%
Thermal coal (Mt)*	363	17%	48%

Source: IEA, IAI, Base Metal Study Groups, WSA, JM, Company Reports, IHS, Bloomberg, Macquarie Strategy, Mar'22 *Seaborne Market



With regards to oil specifically, the chart below illustrates that sharp increases in the oil price, to levels of $100 and higher, have historically provided a very challenging backdrop for growth. The knock-on effects of a higher oil price remains a key factor driving inflationary expectations and our view is that a moderation in the oil price from current levels is required to alleviate more serious concerns around the prospects for global growth.



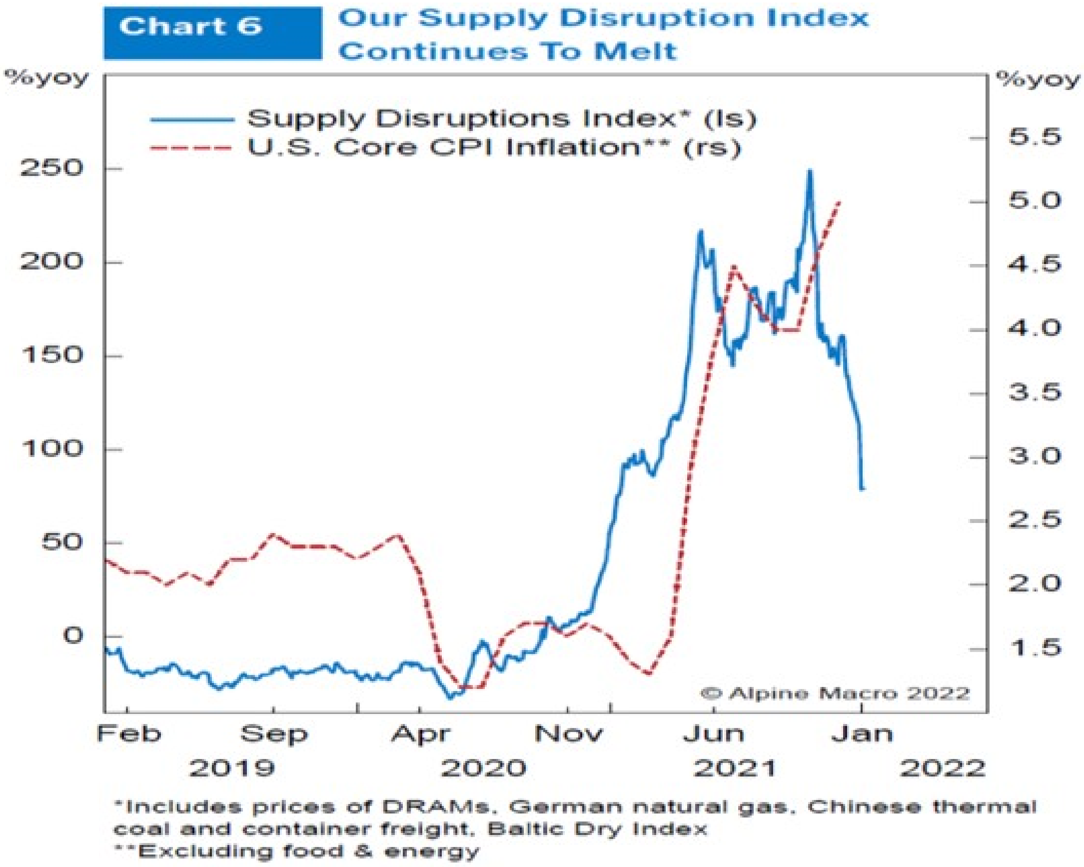
Source: Alpine Macro, April 2022

There is undoubtedly a danger to extrapolating the spot price of oil into the medium to longer term outlook for the global economy. Over time prices are likely to adjust to levels that are more reflective of their fundamental demand and supply dynamics and it is interesting to note that forward looking expectations (reflected in the futures curves) for many commodities, including oil, indicate that prices should come down. How long this takes to ameliorate is the unknown question.

The same goes for equity analysis for that matter - using spot commodity prices to forecast the future earnings streams or profits of companies can lead to a very flawed assessment of their longer term valuation. Whilst the current circumstances may indicate that prices across a range of commodities could remain elevated for some time, we need to be mindful of the fact that should circumstances change, these prices can decline as quickly as they increased.

Supply Side Constraints

Global supply chains have endured a difficult two years. From the onset of the pandemic, the consequences of “lock-downs” has disrupted the integrated and free flowing nature of global supply chain systems. As illustrated in the chart below from Alpine Macro, there was certainly some evidence that disruptions to these supply chains were beginning to alleviate, only to encounter a further set back as a result of the Invasion.



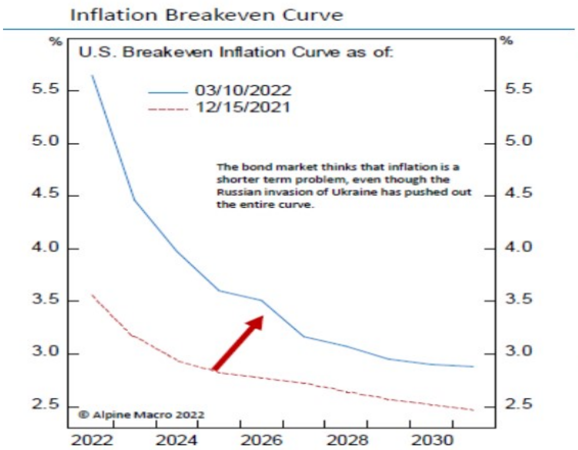
Source, Alpine Macro, April 2022

The disruption to certain supply chain systems has meant that, for certain industries and companies, attention is now firmly being directed at security of supply as opposed to the most cost efficient supply. “On-Shoring” (sourcing or producing supply domestically) could become one of the realistic solutions to address this challenge.

Inflation Expectations and Interest Rate Increases

What does this all mean? What are the implications of these price rises coupled with the complications in global supply chain networks?

The immediate consequence is that inflation expectations have changed – in the US they have moved up considerably since the beginning of the year, driven chiefly by the pressures of rising energy, food and wages. The chart on the left below illustrates the expected inflation curve in December 2021 (red line) and the curve in March 2022 (blue line), illustrating a notable shift and increase in expectations over the next few years, though still moderating in due course.



Sources: Alpine Macro, ClucasGray, I-Graph, April 2022

As could be expected, bonds yields (the US bond yield is shown in red on the right hand chart) have risen sharply in anticipation of central banks having to (eventually) commence on a path of increasing interest rates in their efforts to curb inflation.

If, however, these inflationary pressures prove to be more prolonged, our concern is that it will have negative consequences for the global consumer economy – rising energy and food costs are restrictive for household budgets. There are already indications that this is taking hold in some economies and it is a key issue which we will need to monitor closely in the months ahead.

Investment Conclusions:

Whilst we have noted that the risks to global growth are building and that inflation could be higher for longer, there are a number of positive dynamics to consider from an investment perspective.

We should recall that a global economic recovery was well progressed prior to the Invasion. Many regions and specific industries are still in the process of getting back to their pre-pandemic activity levels. Consumers (notably in the

US and Asia) remain in a strong position – they are employed, have high savings rates and, although rising, still have very manageable debt service costs. There is currently no reason to doubt that components of the recovery will continue.

Historically, we think that it is instructive to observe that regional conflicts have had a limited lasting impact on the global economy and on global markets. Recent examples including the Gulf War, the Yugoslavia bombing and the Crimean crisis were all characterised by a recovery in global markets – in each instance by more than 10% of their pre-conflict levels within a 6 to 12 month period. Selling equities during one of these conflicts has historically been a poor strategy.

China is moving in a counter-cyclical direction – interest rates are being cut with monetary expansion underway and there appears to be an effort to resolve long-standing regulatory issues that have been a concern for the technology industry in particular.

From a domestic perspective, we think that it is quite plausible that there could be some near term economic benefits for South Africa, driven by a combination of the tailwinds from specific commodity prices, favourable terms of trade as well as some signs of economic policy reform (e.g. rail transport and spectrum auctions) that could be incrementally more positive for growth.

Critically, we believe that it is important to try to distinguish between the prevailing macro-economic conditions and outlook, versus the **investment opportunities** which the environment presents. Our asset allocation framework (example below) considers the prospective returns which are able to be derived from a universe of different asset classes. The objective of this process is to identify assets and asset classes that have the potential to generate a **real return** in Rands of inflation plus 4% over a forecast period of 3 years.

As illustrated below, the current environment is looking interesting from a return perspective – for certain assets considerably more so than say six months ago.

There are a range of asset classes, primarily domestic but also global, which have the potential to deliver acceptable real returns.

Source: ClucasGray, April 2022

Portfolio Strategy – What Action Are We Taking?

We are of the view that these kinds of environments present opportunities for patient investors to buy good companies at more attractive valuations. Our strategy has been to use the current environment to **redirect capital within portfolios.**

Specifically, we think that it is prudent to be taking some profits in companies where valuations are elevated (e.g. certain commodity and mining related assets) and to redirect this capital into assets that have been negatively impacted from a price perspective but where the business fundamentals are substantially sound and intact.

We believe that the ability to deliver real returns is enhanced when we are able to buy companies with market leading franchises, robust balance sheets and competent management teams **at lower prices**.

We acknowledge that these kinds of environments can also be very unsettling for investors, and so we would invite you to contact us with any questions that you may have regarding your personal investments.

Kind regards
The ClucasGray Investment Team

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Persons are advised to contact ClucasGray directly should they wish for us to conduct an analysis with a view to facilitating investing in our investment portfolios.

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