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Quarterly Memorandum
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FROM DAWIE'S DESK

Very good advice if you can afford to be in doubt, which is, unfortunately, not a luxury afforded to asset managers, not in this case.

I am referring to the world's major central banks, wondering if they will tighten monetary policy, and, if so, when. I know that I am supposed to have a strong view on this, being an economist, but the truth is that I just do not know...yet. And there are good reasons for my uncertainty...

Firstly, there is no ambiguity: international inflationary pressures are building up everywhere. And that is no wonder. Monetary policy has been stepping on the gas for years, and recently even added to the existing expansionary stance by either cutting interest rates further, or buying more financial assets (quantitative easing), or changing its approach to inflation. They now tell us that they will tolerate higher than targeted inflation for some time (nobody knows how long "some time" is) before they will act.

Secondly, the fiscal authorities (governments) are opening all the taps on various "spending initiatives" to "support" their respective economies. This will inevitably result in inflation, especially since many economies are moving out of lockdown, unleashing a flood of propped up consumer demand. All of this is good news: more people are finding jobs and getting raises. However, inflation is eroding much of the progress that the average worker has made.

For that reason, the consensus among economists – and seemingly also among central banks – is that inflation is, indeed, becoming a problem, and that monetary policy tightening will be required "soon". When that happens, the financial markets will not be pleased and asset prices may come under pressure, which means that we will need to structure your portfolio rather defensively.

The problem is that this may not happen "soon". One reason for this is that the structure of longer-term interest rates is such that they do not really "price in" possible monetary policy tightening the way one would have expected. And, if there is one thing I admire, it is the predictive power of the capital market, and she – it must be a "she" because she has a *yield curve* – is telling us that inflationary pressures are only temporary and inflation is transitionary. Thus, a general tightening of monetary policy will not be required, in which case we do not have to be so defensive with your portfolio.

These are the reasons for my mumbling: I am in doubt, but only a little.

Fortunately, we have a cracking team at Efficient Private Clients. We scrutinise every single word that central bankers say, we analyse every bit of data, and we would even have taken the capital market on a date if that was possible.

My doubt will not last long. Until then, pardon my mumbling...

DAWIE ROODT - Executive Director
Efficient Private Clients

WHAT NOW?

The title of our Quarterly Memorandum a little more than a year ago was: Now what?

We started our commentary with a quote from Satya Nadella, the Chief Executive Officer (CEO) of Microsoft, and possibly one of the best leaders and capital allocators currently in office. Back then, Nadella said that we saw two years' worth of digital transformation in the space of two months. Now, a year later, the question has evolved from *Now what?* to *What now?* Will the changes that we saw last?

COVID-19 and its resultant lockdown of global economies has left massive devastation and loss of life in its wake. But, as global vaccination drives push forward, and workers, entrepreneurs, families, and investment managers sift through the proverbial rubble, we cannot help but to wonder: Will some of the positives from the pandemic last? When economies re-open, will people still prioritise their health, their families, and their general well-being? Will a more flexible work-life balance continue to drive structural changes in the way we earn a living? Or will we return to open-plan offices and hours of sitting in traffic? These questions are important because they will shape many long-term investment trends over the next decade, which will have ramifications for both winners and losers.

The answers to the posed questions will not be simple. But, what is evident from the companies that we invest in, is that many of the temporary changes in how we live our lives, as well as in the global economy, have become structural. That is positive for us as investment managers.

We must also bear in mind that nothing lasts forever and that is why we have cycles. One of the most important things when looking for a good investment is discovering a company with a fundamental source of growth that trades at an attractive price. Nothing lasts forever, but cycles are also shortening. The COVID-19-induced recession of early 2020 happened less than two years ago, but the United States (US) economy looks like it is already in the middle of its economic cycle; China has tightened monetary policy and looks like they want to reverse course; and the only large block that is going to grow faster next year than what it is currently growing, is the Eurozone.

As cycles shorten, investors need to look further into the future and not shorten their gaze. Unfortunately, a short-term focus can lead to investors being influenced, or even trapped, by market noise, leading to sub-optimal investment decisions.

We have not made any significant changes to our portfolios throughout the past quarter. We are comfortable with the long-term prospects of the companies that we own in our portfolios.

So, how do we answer the question: *What now?* At the risk of sounding repetitive, we continue to invest in leading global companies with sustainable competitive advantages and structural growth drivers to preserve and grow our clients' wealth, not only during this cycle but also the cycles to come.

GLOBAL MARKETS AND PORTFOLIOS

Following a slow start to its post-pandemic recovery, Japanese markets surged back to life in the third quarter. Optimism rebounded on the hopes that Japan's next prime minister would spend big to boost economic activity. This followed the news that Prime Minister Yoshihide Suga said he would step down after a one-year tenure. His term was marred by his unpopular handling of the COVID-19 pandemic.

Further afield, US markets were boosted by accommodative monetary policy and continued stimulus support from the government throughout most of the quarter, although September was brutal for markets. On Capitol Hill, the Senate passed a bipartisan infrastructure bill in early August, following months of negotiation. The bill, however, must be approved by the House before President Joe Biden can sign it into power. This will not be easy: House progressives want to pass a separate, $3.5 trillion spending bill, transforming America's social safety net before voting on infrastructure.

To finance these endeavours, Democrats want to raise corporate taxes to 26.5%, from the current 21%. Beyond the political realm of endless debate, underlying US consumer prices continued to rise during the quarter, albeit at their slowest pace in six months, as used car prices tumbled. The labour force also continued its recovery. As a result, the unemployment rate ticked lower to 5.2%. As the economy improves, the Federal Reserve (Fed) is preparing to adjust its monetary policy, and we can expect the Fed to start tapering next year. The central bank will, most likely, also begin to raise rates in 2022.

Geopolitical tensions rose between NATO allies following France's decision to recall its ambassadors from the US and Australia. This followed a US-UK-Australia deal, where Australia ordered at least eight nuclear submarines with support from the US and the United Kingdom (UK). The Australia-US submarine deal replaced a previous agreement between France and Australia, infuriating French President Emmanuel Macron, who seeks to strengthen his support among French nationals before France heads to the polls next year.

European markets closed virtually unchanged as Germany wrapped up its 2021 federal election with Incumbent Chancellor Angela Merkel choosing not to run after almost 16 years at the helm.

Looking further east, Chinese markets had a torrid third quarter following further regulatory scrutiny from the Chinese government. Amid increasing global concern over the pervasive power of Big Tech, China's leadership has decided to crack down on its tech sector. China's regulators also intensified their focus on cryptocurrencies, with a blanket ban on all crypto transactions and mining. This announcement took its toll on the price of Bitcoin and several other significant coins that started to show promising signs of new life at the start of September.

China's property sector has also come under pressure after authorities limited the debt that these companies can

accumulate. China's Evergrande, a Fortune Global 500 company, and China's most indebted property developer, with more than $300 billion in liabilities and an estimated $1.5 million unfinished apartments, stopped repaying some investors and suppliers after running into financial difficulties. The potential collapse of Evergrande sent shockwaves through the financial and property sectors in China and prompted concern that it could impact China's entire financial system, even affecting international markets. These events are ongoing, and investors will be keeping a watchful eye to ensure that their portfolios are positioned so that any potential fallout will be limited.

Thus far, 2021 has seen a strong pipeline of companies that have gone public in various shapes and forms, and the third quarter was no exception. Robinhood, the popular trading platform was one of the most highly anticipated Initial Public Offerings (IPOs) of the year, following the part it played in the Meme stock saga earlier this year. Unfortunately, the IPO was disappointing as it closed almost 8% lower than its trading debut. The company, however, managed to raise $2 billion through its listing, which valued it at $32 billion. But what was even more impressive, was the IPO of Universal Music, the world's biggest music label with a line-up of stars from The Beatles to Taylor Swift, which surged 36% on its stock market debut, giving the company a valuation exceeding $50 billion.

LOCAL MARKETS AND PORTFOLIOS

To say that the past quarter was eventful would be an understatement. The fact that markets are trading at similar levels to three months ago does, however, not mean that there was no action. The third quarter is often volatile, dominated by thin volumes as most of Europe and the US have their summer holidays. This year was no exception as many people wanted to make up for travel opportunities lost during the pandemic.

Local social unrest, uncertainty about Chinese regulators' next move, and the question about imminent tapering by the US Fed, all had a dampening effect on the markets. An ever-strengthening dollar and Chinese markets in turmoil, meant that the largest share on the Johannesburg Stock Exchange (JSE), Naspers, also came under attack. To add fuel to the fire, Prosus initiated one of the largest corporate actions in the JSE's history: 47% of Naspers shares were swopped for Prosus shares with volumes so high that the JSE was unable to open on the 18th of August.

The rand weakened by almost 7% during July and August (traditionally the worst month for the currency), but clawed back all its losses in the first half of September. This is encouraging and supports our view that the positive of an independent, well-functioning justice system overshadowed the negative publicity of recent unrest and looting. It also underlines the fact that the rand was severely undervalued over the past 18 months. The rand continues to be the strongest emerging market currency for the year to date.

Locally, company results showed promising signs with financials and retailers recovering quicker to their pre-pandemic levels than anticipated. Earnings revisions were also mostly positive. Even after the strong recovery, valuations look attractive compared to other parts of the world. A lot will depend on how the Chinese government handles policy issues going forward. It is our opinion that Naspers and Prosus should present an opportunity from current levels. Tencent already came under scrutiny during 2018. Their diversified portfolio reduces risk and the company has a track record of usually playing on the right side of the rules. After a 40% drop in late 2018, Tencent increased threefold during the next two years. Tencent is currently down 39% from its high.

Although most of the "easy money" has probably been made, significant opportunities remain in the local market. A selloff during the July unrest gave us a second chance to buy Massmart. We are confident that their turnaround plan is on track, and that the company can outperform its peers in terms of share price performance.

We also replaced MTN with Telkom. The Nigerian economy, MTN's biggest market, is very dependent on commodity prices. Telkom offers a relative lower risk, and the planned unbundling of their tower business should unlock shareholder value.

Telkom made the headlines after it announced that it would list its masts and tower businesses as separate entities. Gyro, the current name of the business unit that manages Telkom's property portfolio of 6 225 towers, has been operating as an independent business for more than three years. It will be separately listed on the JSE as Swiftnet. Outgoing CEO, Sipho Maseko, hinted in an interview that the next move for Telkom is to list its wholesale fixed-line business, Openserve, separately. Both listings are designed to create market-based valuations for the business units and to unlock shareholder value. The South African government, which owns 40% of Telkom, has given the nod for the separate listing of the masts and tower businesses.

We remain slightly underweight in terms of resources. Chinese concerns and the stronger dollar weighed on commodity prices. We still see value in the platinum sector but will continue to monitor the situation closely, owing to its very volatile and cyclical nature.

Over the past year, commodity investors were rewarded with share price gains and bumper dividends. One of the star performers was newly unbundled thermal coal producer Thungela Resources. The company's shares rose close to 80% during the quarter as investors looked for ways to participate in the coal price rally.

Sibanye-Stillwater deployed capital by acquiring a 50% interest in Ioneer Ltd's Nevada-based lithium project for a price tag of $490 million. The acquisition is a continuation of its strategy to diversify its revenue streams as it continues to build resources for the battery materials market and to look further at leveraging its uranium assets.

Anglo American saw significant improvements in its diamonds business, recording rough diamond sales of $515 million, which keeps the company on track for, what may be, its best year since 2018.

At the moment, the South African playing field might not be as exciting as the global investment arena, but investors can find well-run blue-chip companies at very attractive valuations. The likes of Netcare, FirstRand, Bidvest, and Sanlam are but a few examples. After a very disappointing past six years, there is reason to be optimistic. Volatility will be the name of the game. Unfortunately, we do not have total control over our destiny: 80% depends on the mood of the world. But, if you look past the short-term noise, there are wonderful opportunities to acquire top companies at discount prices.

COMMODITIES

Most commodities closed the quarter in the red, with some pockets of gains being made mainly in the energy commodities. Natural gas prices breached the $5 per Metric Million British Thermal Unit (MMBtu), while coal was strong with the Newcastle benchmark rising by almost 30%.

China's green efforts and subsequent curbs on steel and aluminum activity led to mixed iron ore and aluminum fortunes. Iron ore collapsed more than 40% from the $200 per ton levels seen during the year, while aluminum managed to reach decade highs of more than $3 000 per ton. Further concerns about the supply of bauxite, following a coup in Guinea, helped to keep aluminum prices elevated. Platinum Group Metals (PGMs) continued to feel the sting of chip shortages, which has had somewhat of a crippling effect on auto manufacturing. The white metals eased gains for most of the quarter as demand from original equipment manufacturers slowed down while supply activity remained, easing tightness in the market. Rhodium and Palladium suffered the most in the group, giving up ~29% of prior period gains, while Platinum faired relatively better, capping losses at under 10%.