REZCO ASSET MANAGEMENT

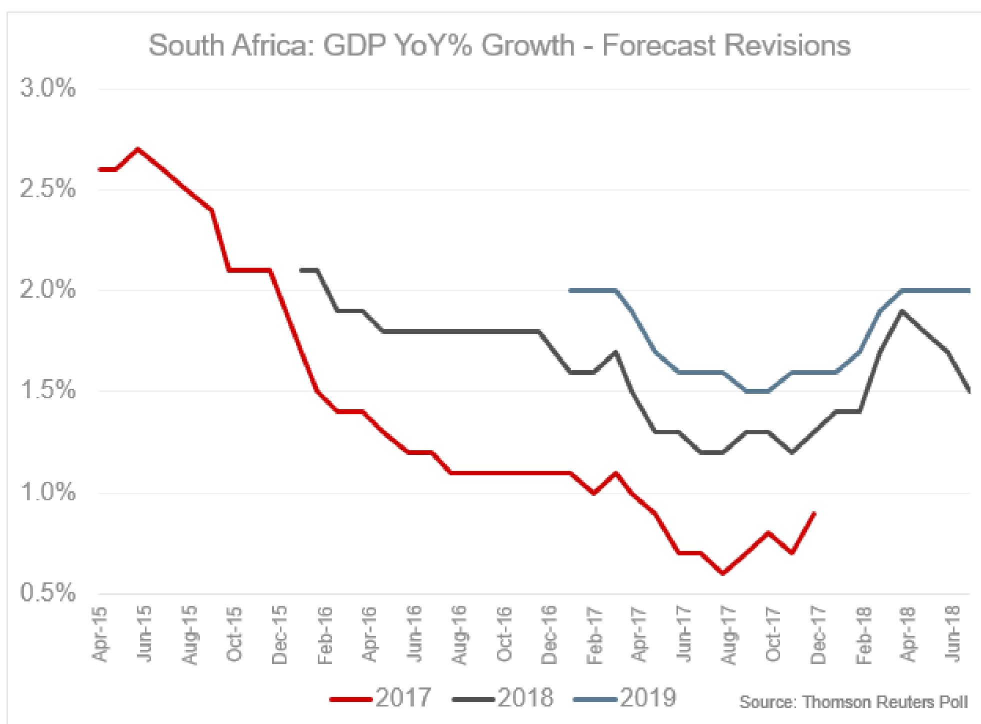
QUARTERLY INVESTOR COMMENTARY JUNE 2018

PERFORMANCE REVIEW

We are pleased to report that the Rezco funds have had a strong performance for the first half of 2018, outperforming peers and the market. This outperformance is largely attributed to our key macro calls materialising:

1. Strong US economy, strong USD, and quantitative easing unwinding.
2. Sluggish South African economy: worsening expectations for SA economic growth; negative earnings revisions for SA Inc. shares.
3. Emerging market sell-off: weak Rand; SA Inc. share prices collapsing off the mid-February peak.

The chart below shows a poll of SA's leading economists' forecasts for what they expect SA GDP growth to be for each calendar year over time. Expectations ran high for 2018's growth through the ANC elective conference and the SONA speech, but as more information became available, the economists updated their predictions and have reduced growth expectations. We expect that the 2019 forecast will also be revised downwards as 2018 disappoints through the year. This is a tough environment for South African companies to grow earnings – market expectations are too high.



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WHERE ARE THE RISKS?

The Rezco funds have been well positioned for the trends mentioned above, but we remain cautious due to two key risks that could impact markets globally:

1. Trade wars
2. Disorderly rise in interest rates

The major risk around the trade war is not so much the tariff, as in isolation the impact is limited, but rather the uncertainty it creates. Uncertainty results in softer economic growth and it can cause share price valuations to become depressed. While a positive outcome could be negotiated, our base view is that the uncertainty will persist as China digs in its heels. China can play the long game, whereas Trump's time in office is ticking. Although sentiment around trade may cause volatility, as earnings growth compounds against a low valuation we would expect significant share price upside for the companies we have invested in.

The US Fed appears to be doing a good job managing the risks around US monetary policy. Our base case is that of an orderly rise in US interest rates and a steepening of the yield curve, but we are concerned about inflation numbers that may surprise to the upside. Given that the market's pricing of interest rates is behind the Fed's guidance, any upside surprise could catch the market wrong-footed and cause a correction in both bond and equity markets.

HOW HAVE WE INVESTED GIVEN THE RISKS ABOVE?

- Rising interest rates: US insurers and banks.
- Trade wars: US industrial stocks benefiting from protection; US competitors outside China.

The global allocation includes investments which benefit from rising interest rates, and more specifically from a steepening of the yield curve. US Banks and Insurers offer good value (growth at a low price / earnings ratio) with additional upside should yields rise faster than the market is expecting.

Should the trade war escalate, there will be winners and losers. Investing in US companies at good valuations with upside optionality should they receive protection is a good way to hedge some of this risk, while still benefiting from a strong US economy.

A good US industrial example would be Whirlpool, where the CPI index for US Laundry Equipment recently increased by 13% after 5 years of negative price adjustments.

Another way to play the trade war is our investment in Samsung, a South Korean based semi-conductor company (memory chips). Without the trade war, Samsung is a good investment, but if tensions escalate then Samsung will benefit from Chinese buyers not being able to access chips from US companies. If the trade war is resolved, markets should rally, especially chip companies on depressed valuations, and Samsung will benefit.

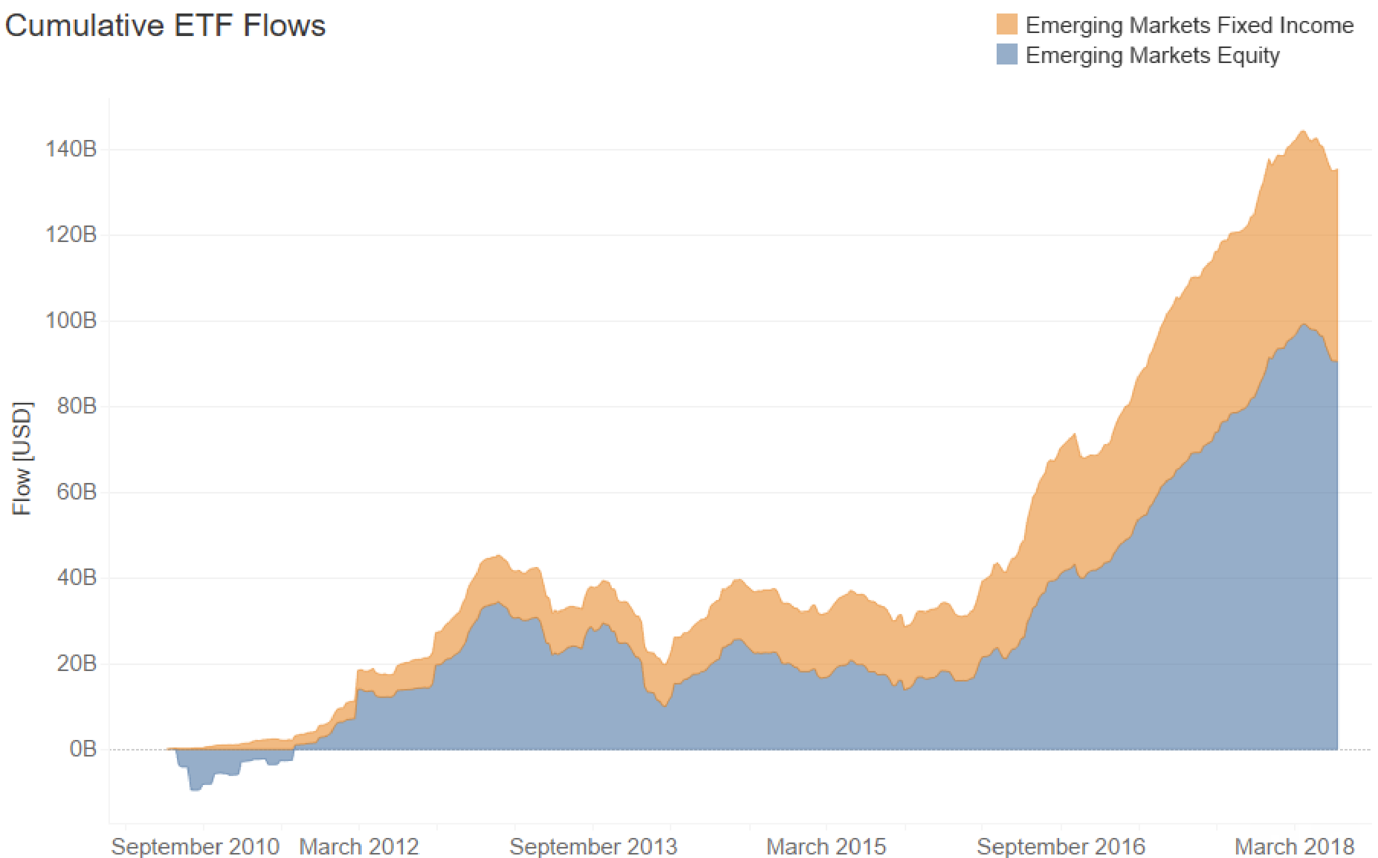
GIVEN THE RISKS OF A TRADE WAR, WHY INVEST IN EQUITIES OVER CASH?

1. While there are significant risks, global growth remains strong and is largely synchronised.
2. Trade tensions, if they escalate, may be insufficient to de-rail global growth, or they may dissipate.
3. Given the concerns, global equity valuations in general are fair, and in specific cases offer good opportunities.
4. Sitting in cash while the market "climbs a wall of worry" is a poor strategy.
5. Rather, cognisant of the risks, we remain cautiously invested in high quality companies benefiting from earnings growth.

IS THERE FURTHER UPSIDE FROM THESE THEMES AND HOW WILL REZCO OUTPERFORM INTO THE YEAR END?

A strong US economy supports inflation and rising yields, and the unwinding of QE. This is expected to maintain negative pressure on EM assets. A strong US economy, however, also backs US brinkmanship globally, and especially on trade. These risks remain front of mind.

SA Inc. valuations appear to be coming into fair value, but economic indicators suggest the SA economy may be worse than we had expected. As global monetary policy normalises, we expected emerging markets to continue selling off – the chart below illustrates that selling may have only just begun.



Despite the optimism around President Ramaphosa, within emerging markets South Africa is one of the worst positioned economies with both current account and budget deficits, over-indebtedness and low GDP growth. The Rand is completely reliant on foreign investment flows into South Africa to hold its valuation.

Given the above, we expect:

1. The Rand to continue gradually weakening through year end.
2. Sentiment towards SA to worsen as the national elections draws closer.
3. Further downside to SA Inc. shares as earnings growth disappoints.

APPRECIATION

We would like to sincerely thank our investors for their continued support. Our long-term track record backs our investment philosophy and style of investing in growth companies at the right price. Markets appear favourable to our style, and we hope to continue outperforming and providing value to our clients.

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