QUARTERLY INVESTOR COMMENTARY QUARTER 2 | 2021

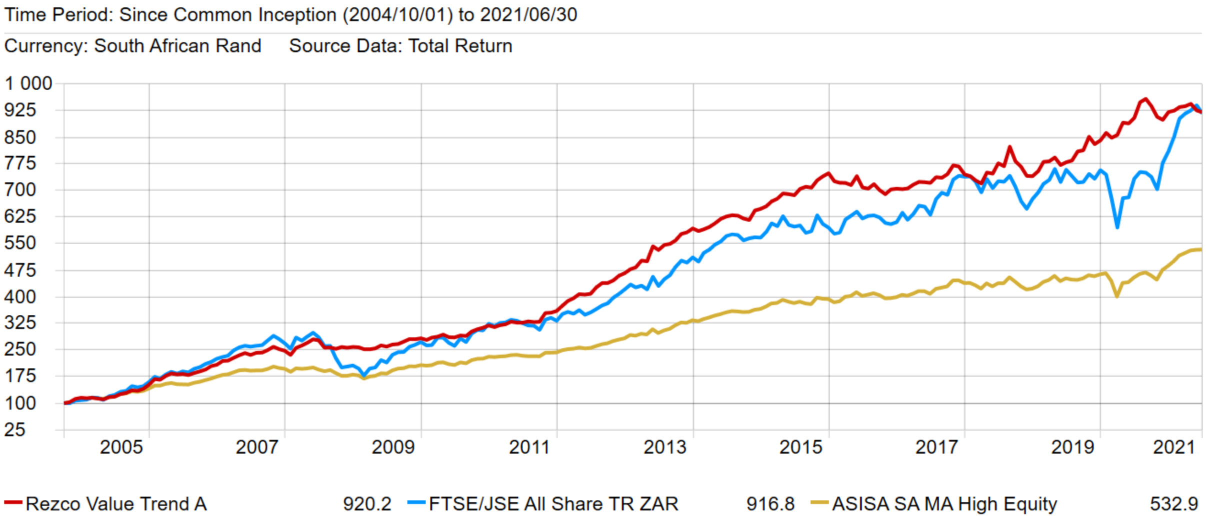
STEPPING BACK A BIT…

The past 18 months have seen huge swings in economies, markets, how businesses operate and changing risks. As eventful and risky as this period has been it has been a very good period for the wealthy; asset owners have benefitted from rising house prices and soaring stock markets, and with access to leverage also lower borrowing rates. It has also been a period of uncertainty, unrest and geopolitical risks, along with a global widening of the wealth gap between countries and within countries.

Despite the risks, both bonds and equities have performed very well. While Rezco avoided the initial covid crash, the risks have kept us largely out of the market. These risks have changed from the initial uncertainty around the disease, to the risk of high valuations as equities, pushed higher by plentiful liquidity, ran ahead of the reality on the ground. Covid's second wave risks kept us out of the market towards the end of 2020, but equities managed to rally through this as the second wave globally was much less severe than potential (the beta variant occurred in an economically insignificant country and the delta variant arrived late enough for the developed world to be largely vaccinated; this line of events was not at all guaranteed). As the calendar turned over to 2021 high valuations and inflation risk has kept us risk averse. One has to ask the questions: Why not just pile into equities given all the liquidity? Why go for such a long period without taking a lot of risk? If the reasons keep changing, are you simply backward looking?

Rezco's investment philosophy has always been highly conscious of risk, the funds have avoided major drawdowns, but also over the years benefited from strong bull markets (as shown in the chart below). Our risk process remains forward looking, always mindful that managing risk is an iterative process. It is not about timing the one-off events, but a careful assessment of the risk vs the reward, and, where we see it making sense, looking to avoid that risk knowing very well that it may not materialise and markets can rally as the risks subside. The lesson to learn as the markets have rallied through all these risk events is not that managing risk does not matter, but that risks are probabilities – the risk event may happen or it may not. The second wave in the northern hemisphere could have been the beta variant or the delta variant, beta would have damaged vaccine confidence and delta would have overwhelmed hospitals. Risk still matters and while many may argue that cash is trash, in a falling market cash is king. Markets are fickle and momentum is dangerous. Retail investors may only buy call options for now, but put options could quickly become a favourite. Building confidence based on a rising market, zero interest rates, low bond yields, continued QE and fiscal stimulus, high economic growth and no inflation has major contradictions which we think ultimately break and result in falling asset prices.

REZCO VALUE TREND FUND



Source: Morningstar

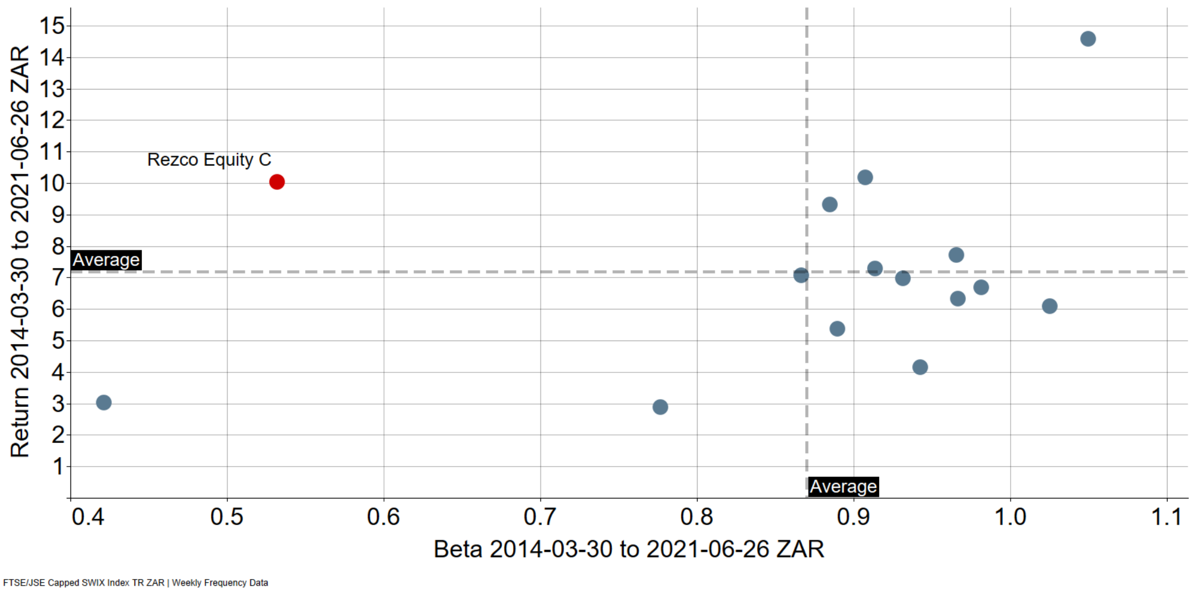
SOUTH AFRICA

At the time of writing, there remains a lot of uncertainty, shock and sadness for what is happening in South Africa. It is indeed a deeply troubling time for our country, but we do see a scenario where we build back stronger with an even more entrenched president more capable of cleaning up corruption and enacting reform. Nonetheless we cannot ignore the negative tail risks for the economy should the situation not come under control, and the low probability risk of some kind of economic sabotage cannot be ruled out at this stage. The economic impact is still being calculated, and the ripple effects on a broken consumer and business sentiment are yet to impact growth. This leaves us more cautious on SA Inc equities which have largely moved sideways through this period.

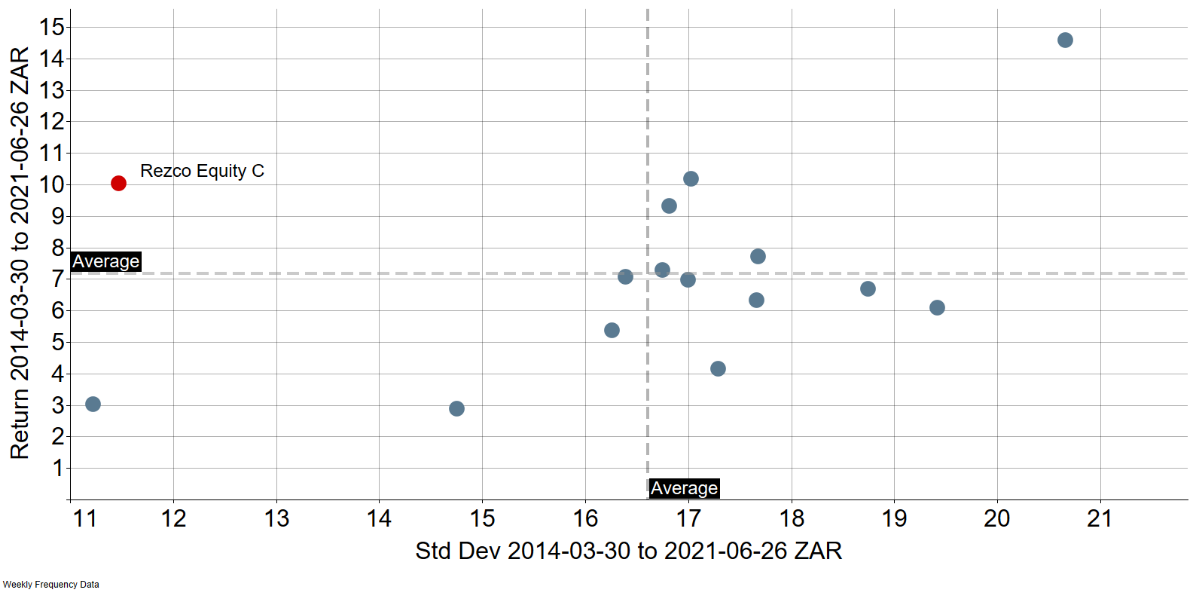
At a time of heightened risk, it is worth noting that we have multiple tools to manage risk within the Rezco Equity Fund, most notably an active style, and being benchmark agnostic allows better quality diversification.

In a time of turbulence, with risk management at the forefront of our minds, we also note that there are always opportunities. The charts below highlight the risk management of the fund, and we think this fund can add value to client portfolios given its lower total risk, low correlation to other funds, and good returns over time.

The below charts show the Rezco Equity Fund’s average beta since inception against large peers (above R500m AUM) in the sector which also manage SA only equity. We do not agree that to get higher returns you have to take more risk over time:



While there are many risk measures, using volatility shows a similar story, lower risk but good returns since inception.



In the following section we dig into detail around our US Inflation views, but it is worth noting here the risk to SA assets should the US be forced into an aggressive hiking cycle due to much higher inflation. South Africa, prior to the looting, was in a good position with a large trade surplus and better tax revenue, a lot of which has been supported by global growth lifting commodity prices. Sentiment was improving, and the low interest rates and consumer support through the pandemic has lifted spending and allowed SA to have a reasonably strong rebound out of the lows of the initial lockdown. Some structural reform was supporting sentiment, and confidence was building that we may soon start to see an uplift of fixed investment into the country. Now, after the looting, sentiment has taken a knock, but could recover should a strengthened leadership enact reform even more quickly. US Inflation forcing the Fed to tighten, however, could unravel the global growth story which would see falling commodity prices, a decreasing SA trade surplus (and moving back to a current account deficit), a weakening Rand would follow due to this and the global risk off sentiment. Rising US yields along with a weaker Rand would see higher inflation expectations locally, and our hawkish leaning SARB would soon increase interest rates into a weakening economy. SA bonds would sell off. This is a big risk for South Africa and keeps us cautious when it comes to taking risk in SA assets, notably in the multi-asset funds.

OUR VIEWS ON USA INFLATION

The key contradiction in the market is around the view that inflation is transitory but growth, stimulus and accommodative monetary policy are sustainable. The below quote from Jerome Powell's (The Chairman of the US Federal Reserve) testimony on 15 July 2021 highlights that one should be careful around being too confident in the dovish view on inflation:

"The challenge we are confronting is how to react to this inflation which is larger than we had expected, or that anyone had expected. And to the extent it is temporary, then it wouldn't be appropriate to react to it, but to the extent it gets longer and longer then we will have to continue to re-evaluate the risks that would affect inflation expectations and be of a longer duration and that is what we are monitoring."

We see the Fed as monitoring inflation, not controlling inflation. Ultimately we see inflation as dictating to the Fed their next move. The new goal to target *average* inflation and waiting for *broad-based* full employment are key changes. The Fed wants to see actual inflation and not forecast inflation, and the Fed only wants to increase rates when the goal of broad-based full employment is substantially achieved. The problem is interest rate changes take a long time to filter through to cool an economy and the post covid recovery is moving much quicker and hotter than expected.

Powell says that <u>both</u>: 1) inflation is very difficult to forecast and 2) we should believe their forecast that inflation will reduce from current high levels down to just above 2%. It is clear that the situation is under less control than what an overconfident market is considering. We see clear risks, not certainty that this will be a problem, but a high probability. The market is trusting the Fed to control inflation, but the Fed is looking to control inflation via inflation expectations and not pre-emptive interest rate hikes – this is fragile.

To be clear, inflation running higher for longer in the US most likely leads to both a substantial bond and equity sell-off. Bonds are clear, but equities also sell off as interest rate hikes and reduced stimulus rapidly cool the economy – equity valuations are based on large revenue and earnings growth discounted at very low interest rates – so in this scenario we see a de-rating of equities and negative earnings revisions resulting in much lower share prices. There is also a lower probability event that a wrong-footed market has a 1987 type crash in this scenario.

Following are five core notes on where we see upside risks to inflation (most references below are to core CPI; the FED focuses on core PCE which usually runs slightly lower than CPI):

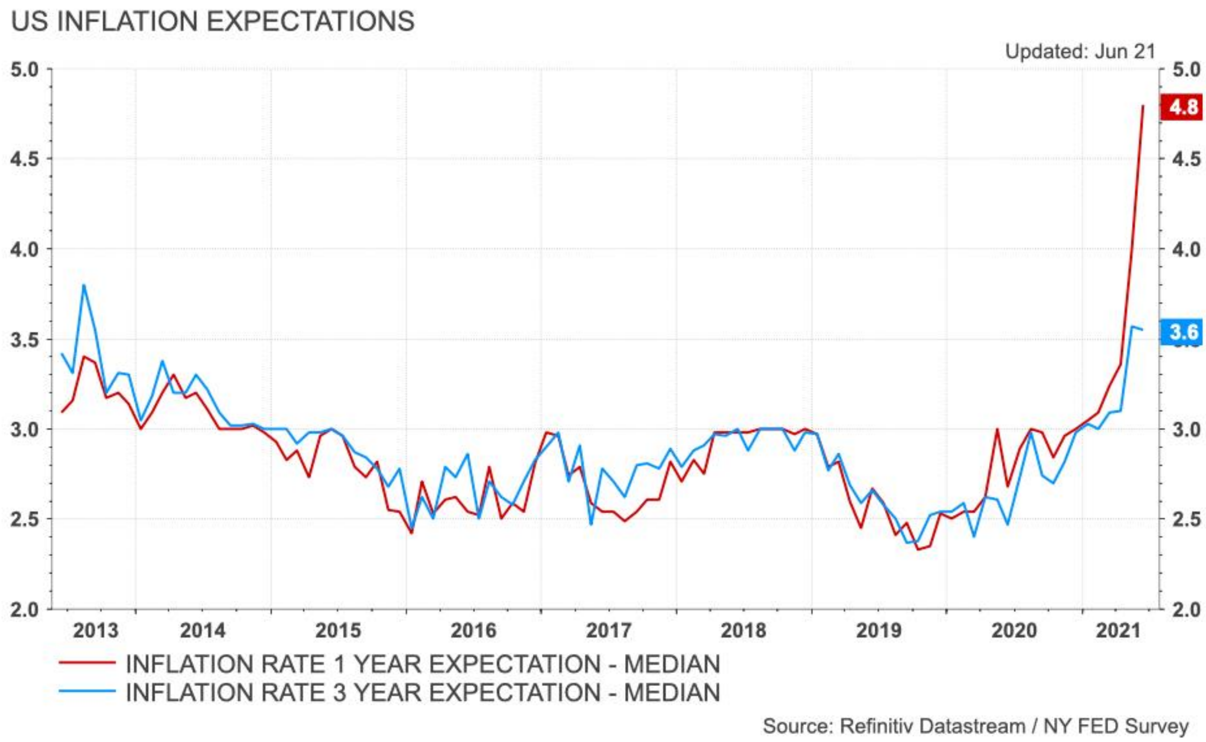
1. **Inflation Expectations (forecasts):**

There is a heavy reliance on inflation expectations by the Fed when setting interest rates, and anchored expectations have been repeatedly referred to in substantiating a dovish stance. Indeed the forecast of inflation by many economists largely boils down to current inflation and inflation expectations (which has an element of a circular reference to it). While inflation expectations have been repeatedly referred to as supporting the idea that inflation is transitory (i.e. high current inflation will revert to longer term expectations), below is an outline of why we think forecasters are starting to move their forecasts upwards.

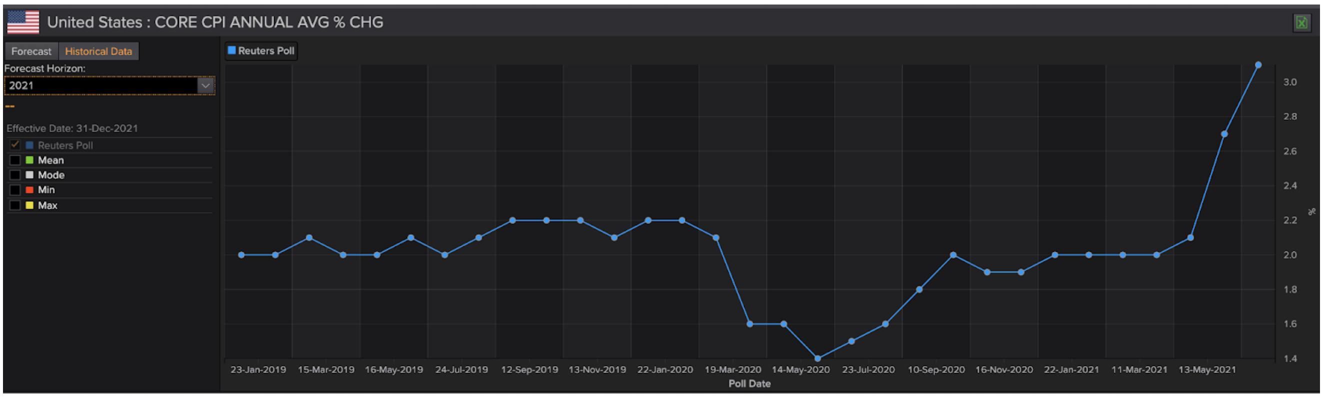
It is worth noting that the current high inflation includes multiple distortions; we are not arguing for inflation of +5% p.a. in the US. Our current view is that Core CPI falls back to about 3% next year but with upside risk over time as housing inflation starts to come through. Indeed the current high inflation print includes base effects in hard hit sectors, the impact of supply bottlenecks that will be resolved, and some inflation will prove to be transitory. This is all true, but what is left over after this is already higher than expectations and there is more transitory inflation than expected, and the forecast period of this transitory inflation is being revised longer.

Given the uncertainty and debate going on around US Inflation, the Fed's confidence, and the large moves in the price of certain goods or services creating distortions and supporting the transitory debate, it is not surprising that inflation expectations (forecasts) are reluctant to move. Expectations are always sticky, but it is important to remember they are sticky up and sticky down. Waiting for expectations to reach levels that are too high is dangerous. Inflation expectations are ticking up, and the longer that short term inflation stays high, the more these longer term expectations are likely to increase. Many a forecaster relies on short term data to extrapolate their longer term views.

The below chart from the NY Fed shows consumer inflation expectations have increased substantially in the short term, but medium term also shows a significant rise - consumers don't seem to believe that in 3 years time inflation will return to target:



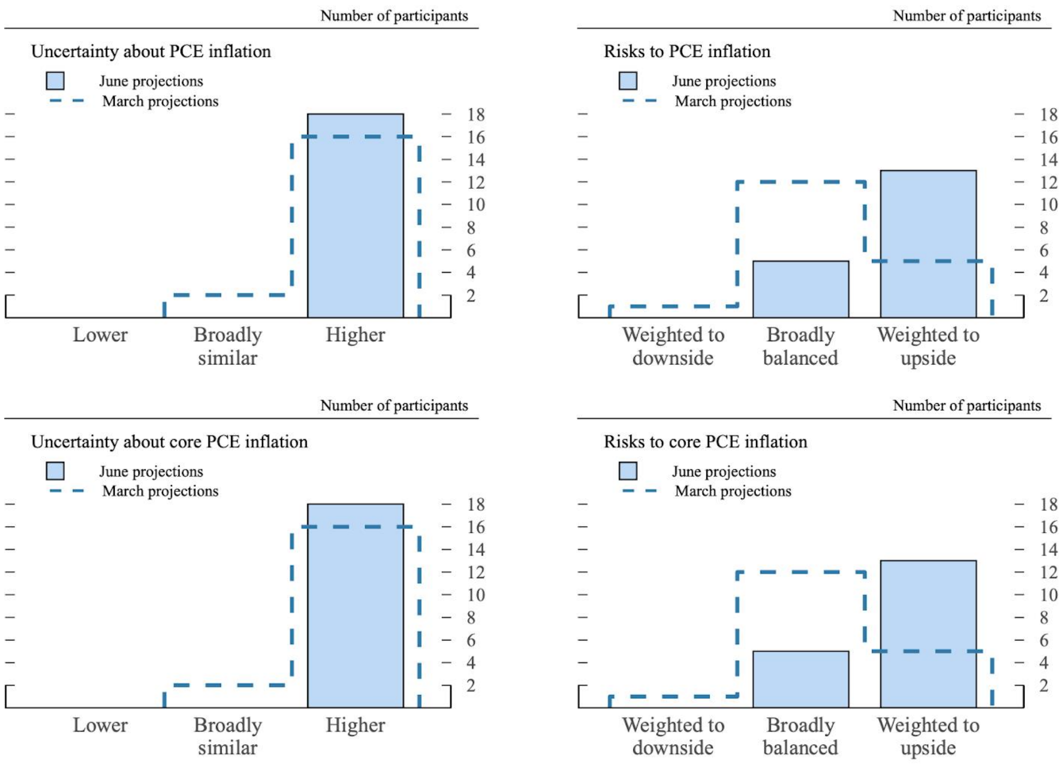
Professionals have also been increasing expectations. Forecasters are well known to be very sticky in their views, only making big changes with the benefit of hindsight. Given the recent upside surprises, the below chart is interesting. It shows the Reuters poll of forecasters' 2021 core CPI forecast has increased to 3.1% vs the forecast of ~2% over the pre covid to May 2021 period. The 2022 forecast of 2.7% by this same group of forecasters shows that the expectation is that inflation will remain higher for longer, and has also been revised up substantially over recent periods.



Note that actual core CPI inflation for the first half of calendar 2021 so far is 3%, so forecasters' view is that after 3% non-annualized inflation for the first 6 months there will be 0.1% inflation for the second six months! This clearly is not a valid forecast, so implicitly what the market is saying is ignore 2021 inflation, it does not matter regardless of the number. Economists may think like this, but not business owners. Surveys here clearly show business owners (price setters) are seeing lots of inflation, both in their costs and their ability to pass on these costs to customers. That will come through in inflation prints over time, and then eventually in the longer term forecasts.

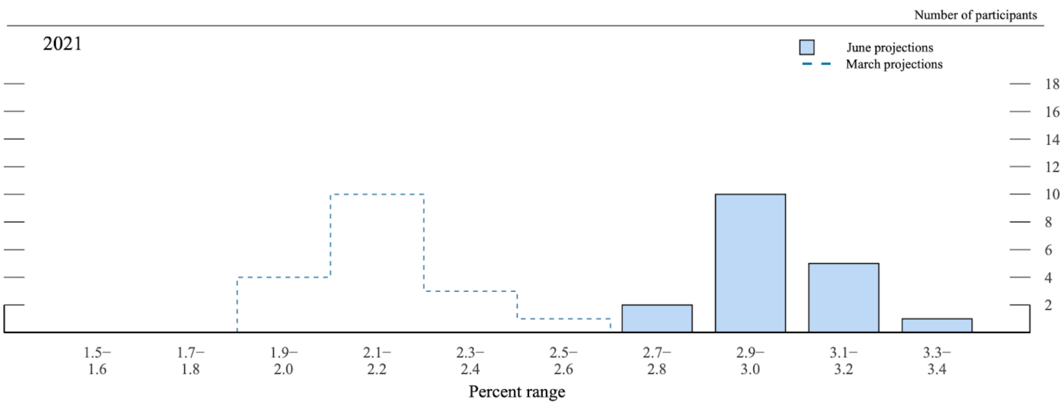
The Fed has made it clear that inflation is currently highly uncertain with risks to the upside, see the below charts from the most recent FOMC statement:

FOMC participants' assessments of uncertainty and risks around their economic projections



Interestingly, the Fed's Core PCE Forecast increased for 2021 by 0.8% in June vs the prior March forecast, and in June the lowest estimate for the year was higher than the prior highest estimate:

Figure 3.D. Distribution of participants' projections for core PCE inflation, 2021–23

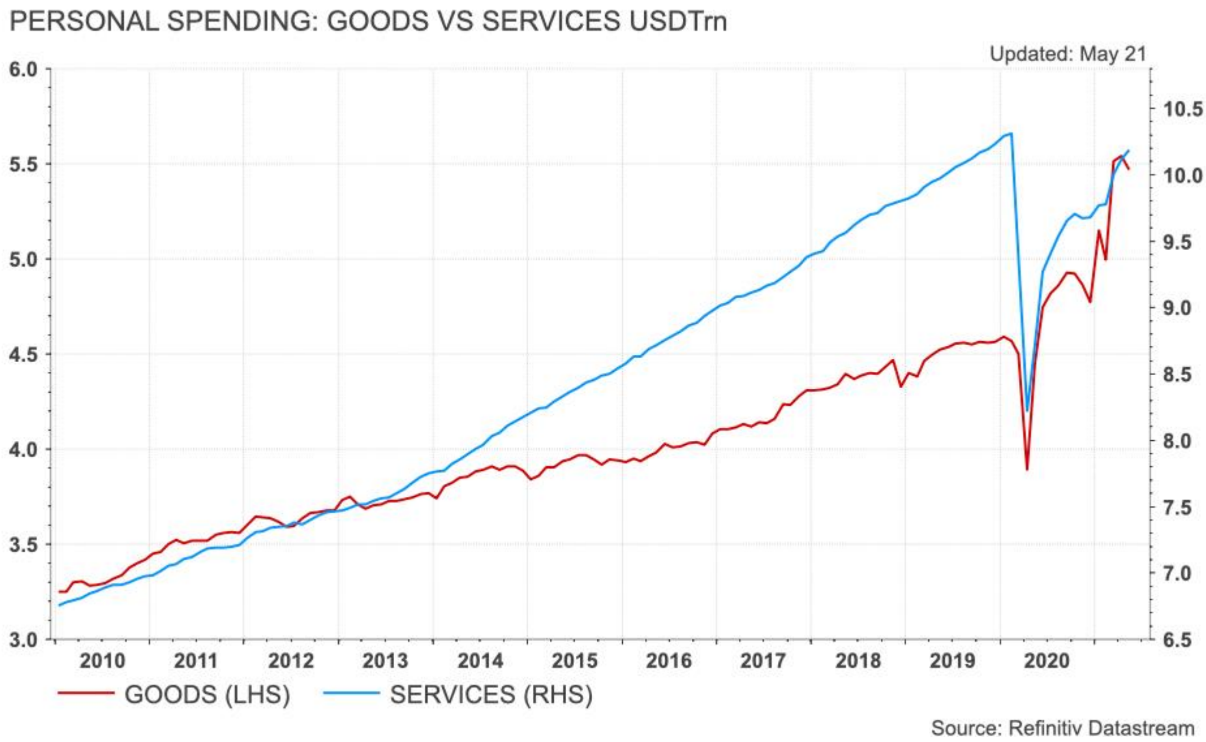


One last point, the Fed's current forecast for 2021 Core PCE inflation is 3%, the problem is that non-annualised inflation for the period Jan 2021 to May 2021 is 2% (and there is high confidence the June print will be about 0.5% given CPI and PPI have already reported). This takes first half core PCE to about 2.5% with the Fed effectively forecasting a total of 0.5% inflation for the entire 6 month period to year end. We might see that in July alone at the current rate! It is clear the risk is high on this forecast, but one must question the confidence of later years forecasts given how far out this year's forecast has been.

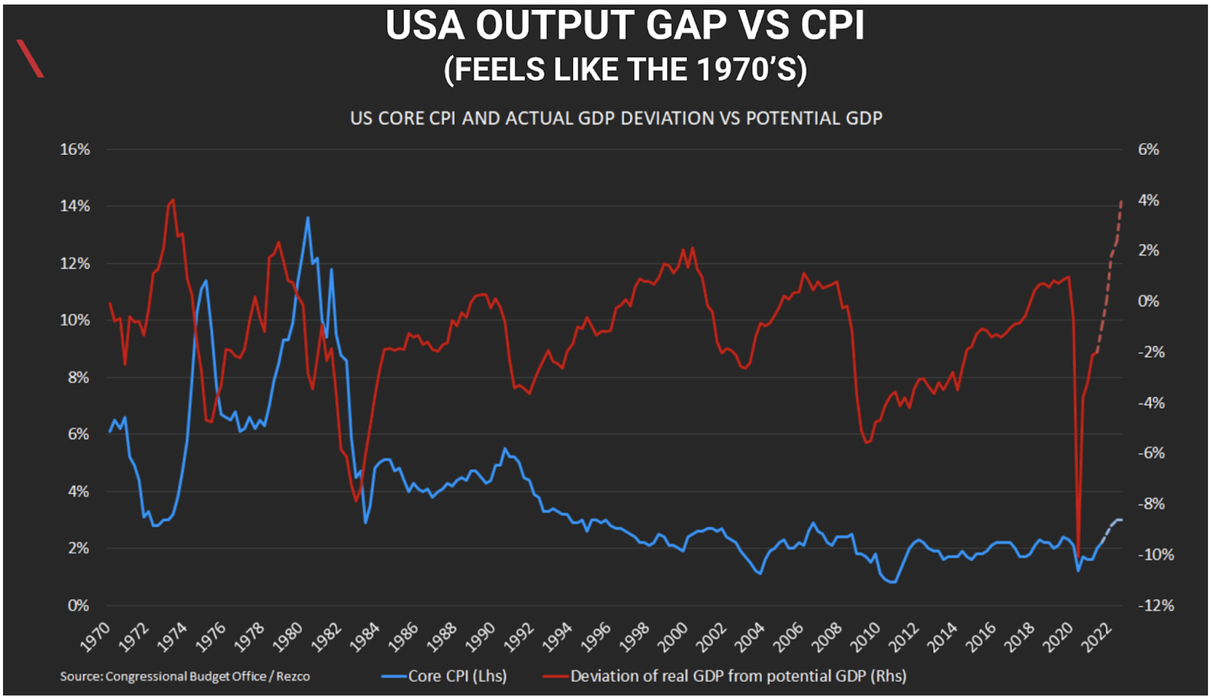
2. Supply shortfall = Excess Demand

Much has been said about supply shortages being temporary, as the economy opens up so too will supply catch up to demand. This helps to support the idea that inflation will be transitory: as supply catches up, price increases will slow down. This is very important, as normally price increases feed into further price increases given the dynamic and complicated web of activity involved in an economy. The idea of transitory inflation is not a rock solid economic concept tested through time, on the contrary what we do know is that price increases normally lead to more price increases.

Looking at the massive increase in spending on goods in the US economy, it is difficult to argue that goods inflation is simply due to supply closures and disruptions, this looks like excess demand with supply scrambling to catch up. Services (to May) are still sluggish but will increase rapidly as the economy opens up (this will add to the already high YTD inflation).



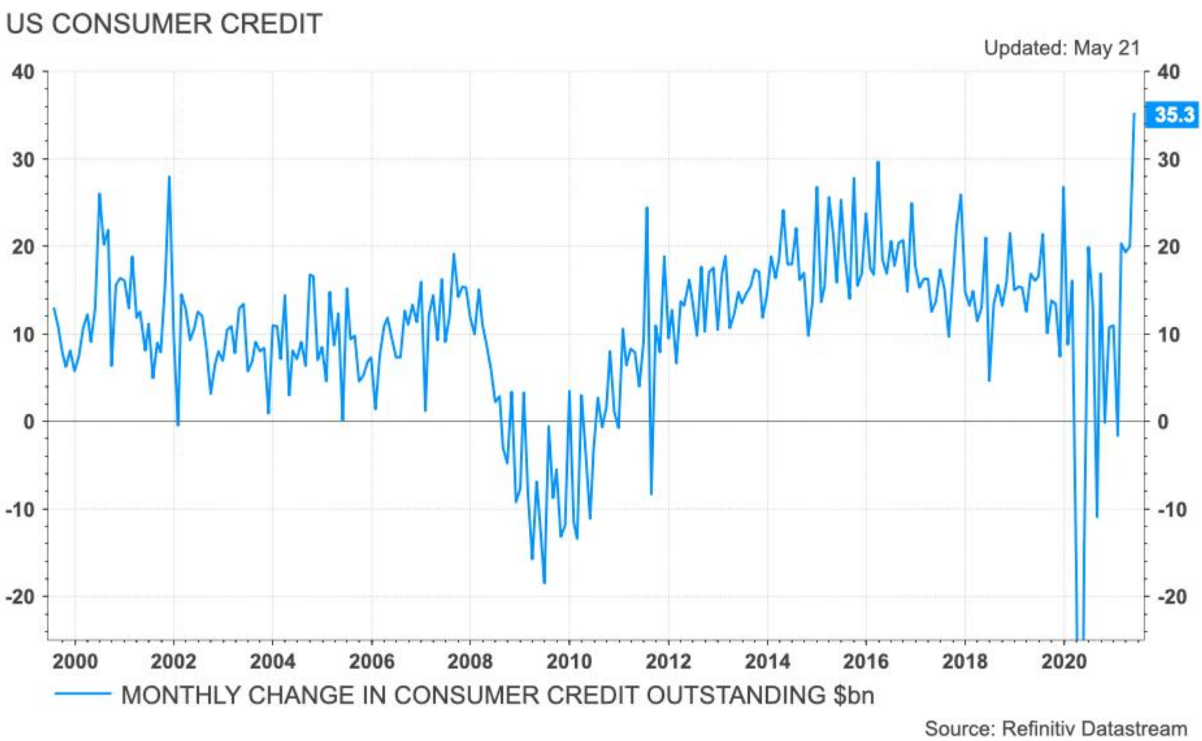
A broader view would be to look at the output gap, given massive GDP growth expected for the US, the expected output gap is only matched in the US by the period in the 1970's.



3. The money is not leaving the system

By now most have seen the charts showing how much money has been printed in the US. While it is staggering, the argument that this is not inflationary is due to the view that the velocity of money has decreased. As the economy opens up, and people borrow and spend more, we see this velocity increasing substantially.

We know banks have solid balance sheets and surplus capital. They are desperately wanting to lend money out, and indeed May 2021 saw the largest amount of consumer credit drawn on record:



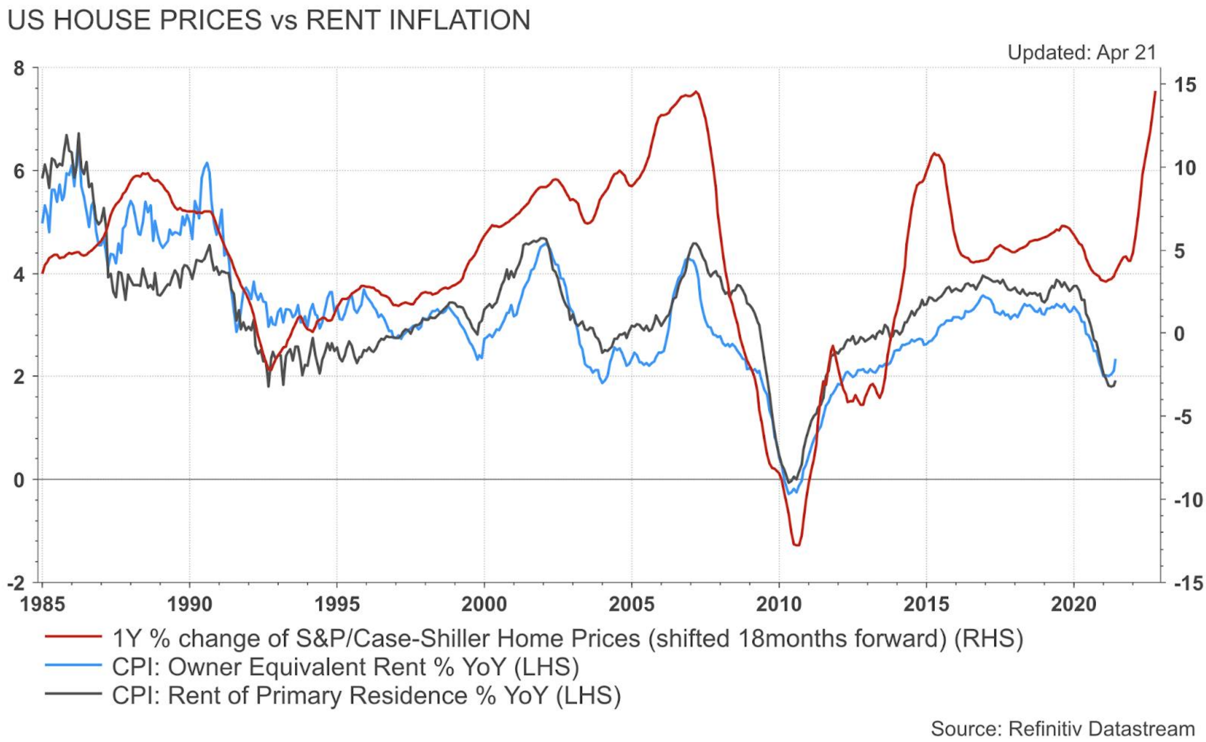
So banks are lending while the economy opens up, adding fuel to the fire. In the GFC when QE pushed liquidity into the economy, it went right back to the Fed as capital controls were increased. This time, with more QE, it is not going back to the Fed but rather will be lent out and spent.

On top of this, the consumer balance sheet is strong, with pent up savings sure to fuel increased spending smoothed out over the coming quarters.

4. House prices lead inflation

Many are making it clear that categories like used car prices, airfares and hotels are the main contributors to the upside inflation surprises but are transitory or coming off a very low base. While this argument is true, it is incomplete and suggests self-confirmation bias. Rent is the largest contributor to inflation, but rents are currently dragging inflation lower, and this despite massive house price increases. This is a major, sustainable, tailwind to inflation through 2022, but we see rent rising faster also in late 2021 due to the base effects of apartment rent in cities as lockdown measures saw a V shape in major cities apartment rents.

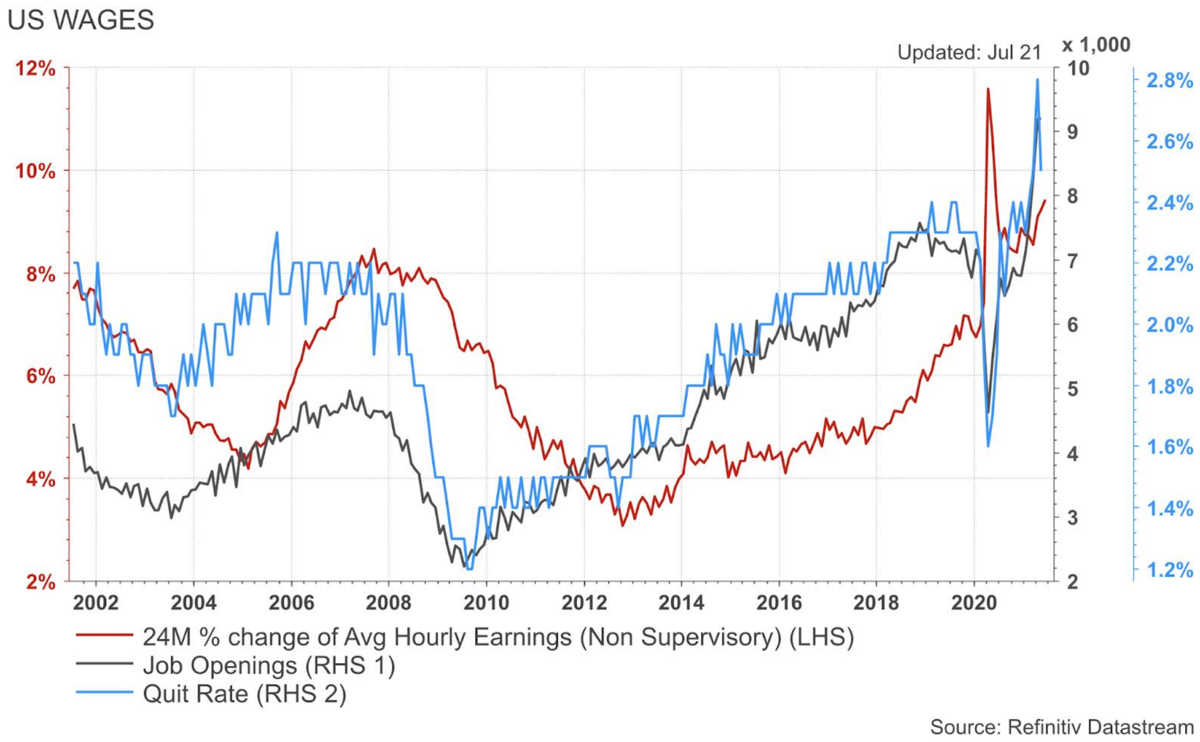
Looking at the below chart, we think it is clear where rental inflation is heading:



5. Wages are rising fast across the board

There is a labour shortage in the US which inflation doves are hoping will be resolved as people are vaccinated and schools fully reopen. Rising wages are not transitory and will add to inflation over time.

The below chart shows that the quit rate and job openings are higher now than at the pre GFC peak, and also wages are rising faster:



6. Lastly, there are some other inflationary trends we are seeing which are not transitory:

- ESG will be inflationary, especially environmental. While protecting the environment is important, it is clear it costs more to do so, this will come through in prices. While costs to produce goods or services that are better for the environment are clearly higher and thus inflationary; it is also worth noting that people appear more willing to pay higher prices in these cases.
- Given the strong housing and equity markets, we expect a substantial volume of people retiring and leaving the workforce, this may result in a lower number of workers at a period when there is a shortage. This will support wage growth and thus inflation. As a side note to this: the Fed is targeting full employment, but we do not know where the labour force participation rate will land, and thus the economy may reach full employment before the Fed realises, creating policy risks.
- The trend of supporting wages for lower wage earnings, unionization of the labour force, a culture of workers' rights, while ignoring the contentious debate on some of these matters, we see this trend as inflationary.
- China is no longer a deflationary force for global goods.
- Geopolitical risks have reduced an aggressive globalisation trend focused on cost. Risk is now a much bigger concern, which means sometimes paying more to produce goods.

CONCLUSION

Both the local and the global environment remains highly risky in our view, with record asset prices misleading investors into taking too much risk. US inflation remains a substantial risk which unravels the positive feedback loops supporting an overpriced market reliant on the status quo.

We take managing client money very seriously, and part of this means remaining humble to acknowledging the other views in the market, always testing where we could be wrong. While the multi-asset funds we manage have substantially lagged markets for the past 9 months, we have been very focused on the risks to client capital. As more economic data has been released in developed economies, especially the US, our conviction has increased that rising US Inflation poses a substantial risk to equity and bond returns. While this is yet to play out, and indeed may not, the risk to the downside is large enough for us to view this time as a period to preserve capital rather than chase growth.

As always we remain grateful to our clients for the confidence you place in Rezco to manage your hard earned savings through the ups and downs of the market. We continue to remain highly focused on our goal – preserving capital and creating wealth through generating risk-adjusted returns for our clients.

ROB SPANJAARD
Chief Investment Officer

SIMON SYLVESTER
Co-Portfolio Manager