REZCO

QUARTER 3 | 2021

Market Commentary

The period to end October 2021 has seen rising equity markets, rising inflation expectations, increased economic growth risks, increased geopolitical risks, and volatile and rising global bond yields. The funds have underperformed over this period but our conviction remains high that equities and long term bonds carry substantial risk of capital loss in the short term.

This note will outline how we view the current situation, how we think markets and economies will play out going forward, and then some forward looking comments on fund positioning.

Before digging into the details, we think it is worth considering an aspect of our investment philosophy around managing risk through the cycles...

A short note on waiting for markets to correct

At Rezco, we look to manage risk and not time markets.

Managing risk is an iterative process of working with probabilities to take higher risk over periods of higher expected returns and avoiding risk when the expected payoff is low or negative.

Two important aspects of this:

- Risk involves probabilities and not certainty, positioning for it means the risk may or not play out. It is an iterative process over time which we expect to add value.
- Market timing doesn't work, greed and overconfidence staying in an overstretched risk asset market generally lead to not getting out in time. Risk management does work, but can entail very lumpy relative performance (ie periods of large under and out performance). This type of performance can be unsettling, but market bubbles are times of high investor emotions.

A very well regarded market commentator, John Authers, commented in his daily note[1] on Bloomberg on 27 Oct 2021:

Markets are most likely in a bubble…

Bloomberg Opinion

Markets

It's Becoming Tempting to Try Timing the Bubble Again

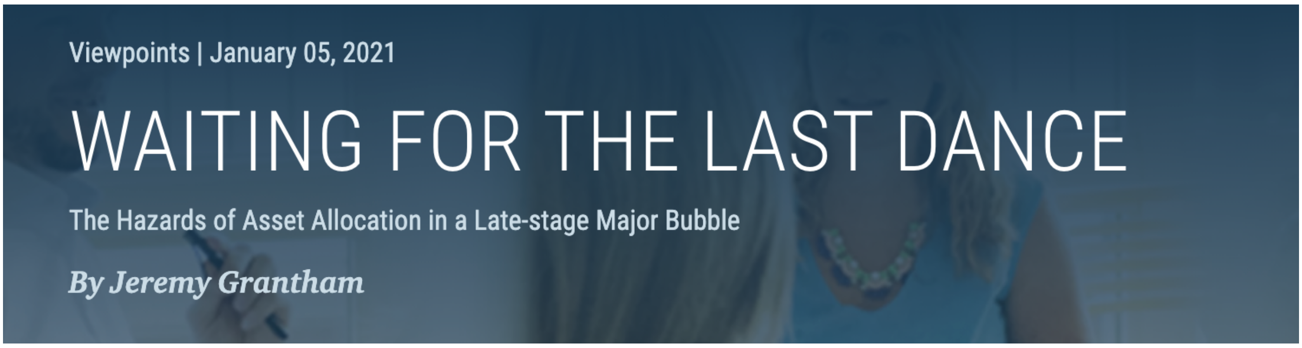
With stocks at a record and Tesla topping a $1 trillion valuation, this seductive though near-impossible idea is regaining currency.

By John Authers +Follow
27 October 2021, 06:00 GMT+2

1 https://www.bloomberg.com/opinion/articles/2021-10-27/stock-bubble-timing-entices-again-with-tesla-topping-1-trillion?srnd=premium&sref=pp5WIoMA

So it seems we are in a bubble, but...“Beyond that there is the law of the jungle. Being early is just a way of being wrong. If the bubble is still inflating, you risk embarrassment and regret by exiting. If you’re a professional fund manager, you also face the risk of looking bad relative to peers, and suffering outflows as clients go elsewhere. Value managers who stuck to their guns in the late 1990s had often lost their jobs by the time the bubble burst. Even if you know you’re in a bubble, the conventional wisdom goes, it’s best to stay with the herd.”

...but better stay in the herd or your career will be at risk!



Calling the market a bubble back in January, Jeremy Grantham[2] made this observation:

“These great bubbles are where fortunes are made and lost – and where investors truly prove their mettle. For positioning a portfolio to avoid the worst pain of a major bubble breaking is likely the most difficult part. Every career incentive in the industry and every fault of individual human psychology will work toward sucking investors in.”

Career incentives and behavioural faults suck investors into a bubble, timing the exit perfectly is not possible, so most don’t even try.

“However, for any manager willing to take on that career risk – or more likely for the individual investor – requiring that you get the timing right is overreach. If the hurdle for calling a bubble is set too high, so that you must call the top precisely, you will never try. And that condemns you to ride over the cliff every cycle, along with the great majority of investors and managers.”

The idea of career risk (or fund managers’ incentives) is that it is better to perform in line with the herd, regardless of what that performance does, than risk losing your job or client assets. At Rezco we do not apply this philosophy, and our career risk is not factored into our decision making. A major reason we can do this is through the support of our valued clients who understand why they use our funds, and what their purpose is within a diversified portfolio. Another part of managing this risk is an internal culture of total risk management, being benchmark agnostic, and having a long term active asset allocation track record that has added value.

At Rezco we aim to manage our clients’ total investment risk, not our career risk. This sometimes means sitting on the sidelines.

[2] https://www.gmo.com/americas/research-library/waiting-for-the-last-dance/

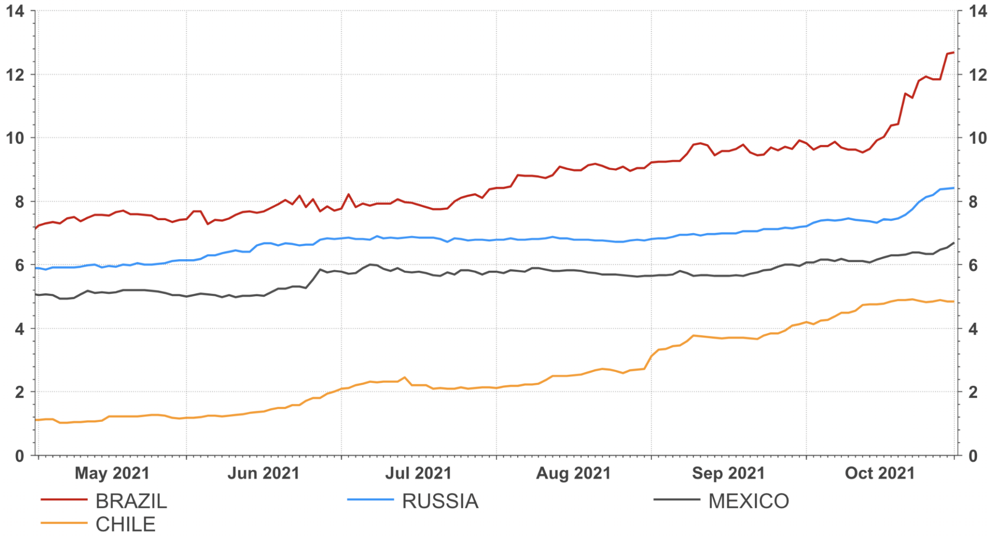
Turning back to the problem at hand

We remain of the view that equity prices are overstretched, and risks are too high to be buying (or holding) a lot of equity risk. The bond markets have started pricing in inflation, but not yet the risk inflation will have on bond and equity markets. The nuance that the market hasn't yet priced in, which is crucial, is this:

There is inflation AND equities will keep going up: inflation will mean revert without strong intervention (the transitory argument)	vs	There is inflation AND we could be in a risk asset bubble: inflation will come down only when restrictive monetary policy brings it down (along with economic growth, company earnings and equity & bond prices)

The current situation

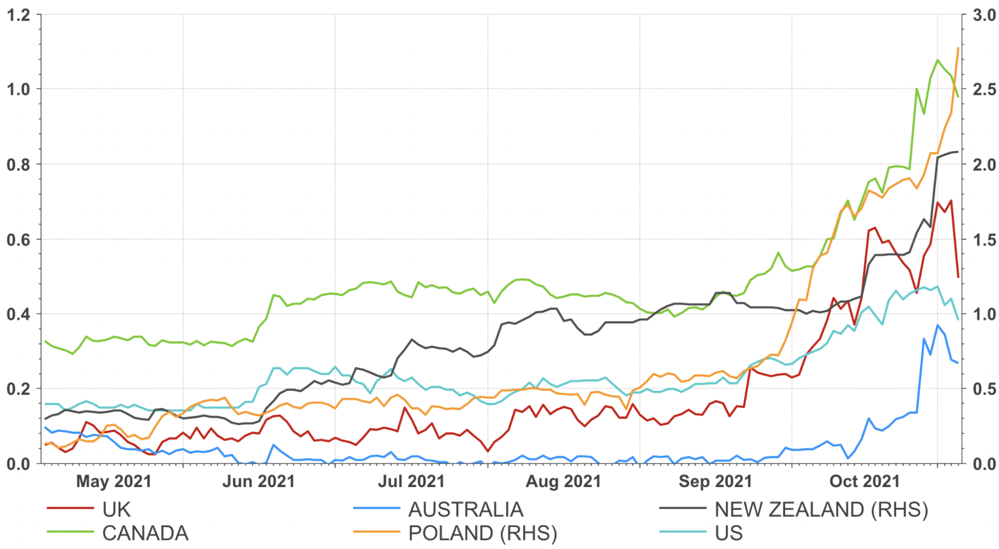
BOND YIELDS - 2 YEAR



Source: Refinitiv Datastream

Over the last few months there has been a concurrent pivot towards a more hawkish outlook across the world. Emerging markets were first to acknowledge inflation, with their economies more susceptible to the global swings - Mexico, Brazil, Russia, Chile have all swung hawkish, some with very large interest rate hikes. This can be captured in the yield on bonds with a 2 year maturity - rising yields capture both expectations and actual rate increases.

BOND YIELDS - 2 YEAR



Source: Refinitiv Datastream

The UK, Poland, Canada, Australia and New Zealand have all moved to a hawkish stance, most notably over October when it became clear the support for inflation being transitory was waning. The moves here are more stark relative to the above emerging markets given the low base off which these yields are coming off - 6 months ago these rates were near zero.

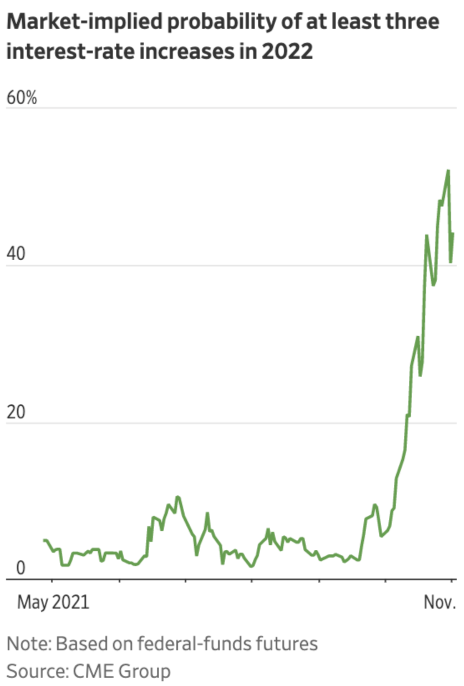
The ECB has been slow to react (which may be understood in their prior policy errors), while Japan and China are special situations, with their PPI's at massive highs being more important for global inflation from these major exporters. The risk is that inflation is global, it is not normal for so many countries to simultaneously become more hawkish. The common threads suggest more persistence and higher risk to the transitory narrative that equity markets are relying on.

These central banks pivots are required to keep confidence, but in many cases the market moved first. A lack of central bank credibility is a substantial inflation risk. The US Fed met earlier this week, and seemed to show higher uncertainty in their predictions, and the market has started questioning their confidence in the Fed's predictions - credibility remains largely intact for now, but risk is building. The US Fed is taking a lot of risk by hoping that the normal functioning and flexibility of the economy will reduce inflation without the need for monetary policy intervention. The next few sections outline why we think this is a major risk and also why we think it is unlikely inflation self reverts. Furthermore, markets seem comfortable with only a few small rate hikes being sufficient to manage inflation, we think the rate hikes will need to be larger than expectations in order to reset inflation lower.

Bond markets are moving ahead of central banks - their credibility is at risk.

So while we at Rezco have been arguing that there will be inflation, the argument now seems no longer necessary. The argument has shifted to what is required for inflation to move back to target and how long will it take, and what will the impact of this be on markets. Indeed, it is easy to say there is inflation and markets are at record highs, therefore inflation doesn't matter. We don't think it is so simple, and it hinges on how economies will need to re-establish inflation anchoring post this inflationary period.

Relying on inflation self reverting is very risky - the short term inflation forecasts have been wrong over the last 6 months, why so much confidence in the next 6 month forecast?



From transitory to tightening

The transitory debate is losing steam - the mechanisms for inflation self reverting are breaking down. Inflation could mean revert back to 2% if:

1. Inflation expectations remain anchored - but expectations are already rising
2. Strong labour and goods supply response - but supply bottlenecks and labour shortages are occuring

What it will take to get inflation back to target is the new uncertainty, current inflation is no longer up for debate.

The idea of waiting patiently for inflation to fall carries risk for policymakers who understand the roughly 18 month lag of monetary policy intervention within an economy. Many developed economies are built on negative real rates, very low nominal interest rates, printing cash, budget deficits. This works when there is no inflation. It works when secular trends are deflationary - wages are not going up quick enough (globalisation of production), cost of goods are deflating (globalisation and productivity enhancements). It doesn't work when global trends are inflationary - labour rights and wage growth, de-globalisation, environmental concerns, supply chain bottlenecks. Waiting for inflation to self revert carries substantial risk that policy makers are unlikely to take. The Fed are holding out for now, but the data will likely lead to increased pressure and a move from behind the curve to significant tightening.

Transitory arguments are running out of support from real world data and central banks seem to be hoping it will all work out fine without any intervention. This is risky given intervention, if late, still has an 18 month lag until impact!

Inflation pressures are building, not easing

The following points highlight why inflation is a building risk (if no intervention) going forward, that the trends seem supportive of sustained high inflation and not a self reverting inflation scenario. We see the building of inflation pressure as requiring intervention to cool, hence why this is a major risk.

Multiple trends are leading to inflation building, and not already fading away back to target.

1) Environmental impact on inflation

Globalisation of production is generally good, but mingled in has been more pollutive production shifting to countries with the most lax costs to polluting. This has been deflationary in the past - ie shifting production from high to low environmental cost jurisdictions. That is changing, and China appear to be making it clear that they are willing to cut production of their most pollutive products which are generally exported into developed markets. It will take time, but pricing the cost of pollution will be inflationary as this cost will need to make its way into the price of goods (this most likely will be a good thing for the environment, but nonetheless is inflationary). It appears China, spurred on by an electricity shortage, may be at the early stages of adjusting to this.

Most forecasters are not factoring in the substantial inflationary effects (costs) of reducing global warming.

2) Labour is tightening

In the US, high job openings, quit rates and high wage growth all point to a tightening labour market. Management commentary from listed companies, as well as the Fed's beige book[3], all point to a very tight labour market. There are also question marks around the number of increased (or abnormal) retirements, with one Fed researcher[4] putting the number at slightly over 3 million extra retirements in the US.

Dovish commentary in the US has emphasised the total number of people who have left the labour force post covid of 5.25m, with the idea that there is still slack in the system as most of them would likely return at some point. This idea around excess retirements would reduce that slack by 3m and thus make the economy much closer to full employment and more in line with the macro statistics showing major tightness. On top of this there is the uncertainty of how many others will rejoin given child care requirements, wealth effects, geographical moves and work from home trends. It carries a lot of forecasting risk to assume most of those who worked pre covid want a job post covid.

Some forecasters are hoping a swing from goods to services in the US will ease pressures, but labour is already tight and wages are rising - even faster in the services economy than in the manufacturing sector.

3) Rental inflation has already occurred and will find its way into the inflation print

Rent increases tracked outside of the US CPI data have already had massive escalations, it is well understood that the CPI data lags, and thus rent inflation is not a risky prediction from here. Single family home rent inflation is getting close to 10% YoY[5], apartment rents rising more than that[6], but the US CPI data is still only showing YoY inflation below 3%.

Rents have already accelerated substantially, but are reflected with a lag in the inflation data.

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3 ://www.federalreserve.gov/monetarypolicy/beigebook202110.htm: see the employment summary
4 https://research.stlouisfed.org/publications/economic-synopses/2021/10/15/the-covid-retirement-boom
5 https://www.corelogic.com/intelligence/single-family-rent-growth-approaches-double-digits/
6 https://www.apartmentlist.com/research/national-rent-data

4) Energy prices still to pass through

Global political trends are supportive of high energy prices to dissuade carbon demand. If only considering pollution then this is good, and managed over time arguably also good in a more dynamic system. The reality is that in the short to medium term rising energy is inflationary, initially in the headline number, but filtering through to core through it's role in providing any good or service.

Energy is a new area of inflation - the abnormal spikes seen in many categories are not simply one offs but a sign of insufficient global capacity and strained supply chains that will manifest in multiple different ways over time.

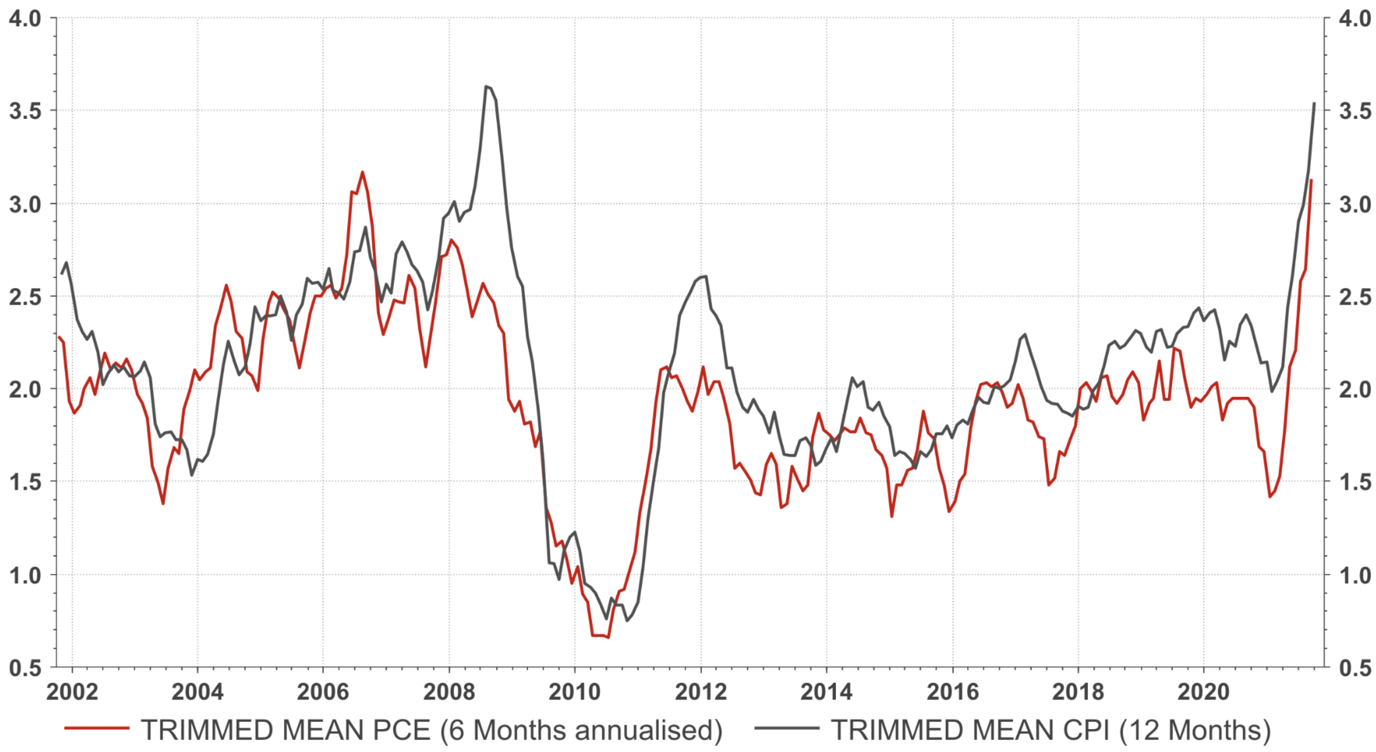
5) Supply chain bottlenecks are not easing

Major US companies have been presenting results to investors over the last few weeks, and a clear theme has been continued supply chain bottlenecks, input cost pressure, logistics issues and rising costs. These are forward looking statements. Some companies are expecting them to be resolved over time, but many are also repositioning their companies to operate with more control of their supply chain.

6) Trimmed Mean measures are rising

Looking into the data, we don't see inflation subsiding. One method is to look at trimmed mean inflation metrics - this is where the highest and lowest inflation categories are removed to show what underlying inflation is doing in an economy excluding the monthly noise. These metrics are rising, and this shows a broadening out of the inflationary trends.

US INFLATION

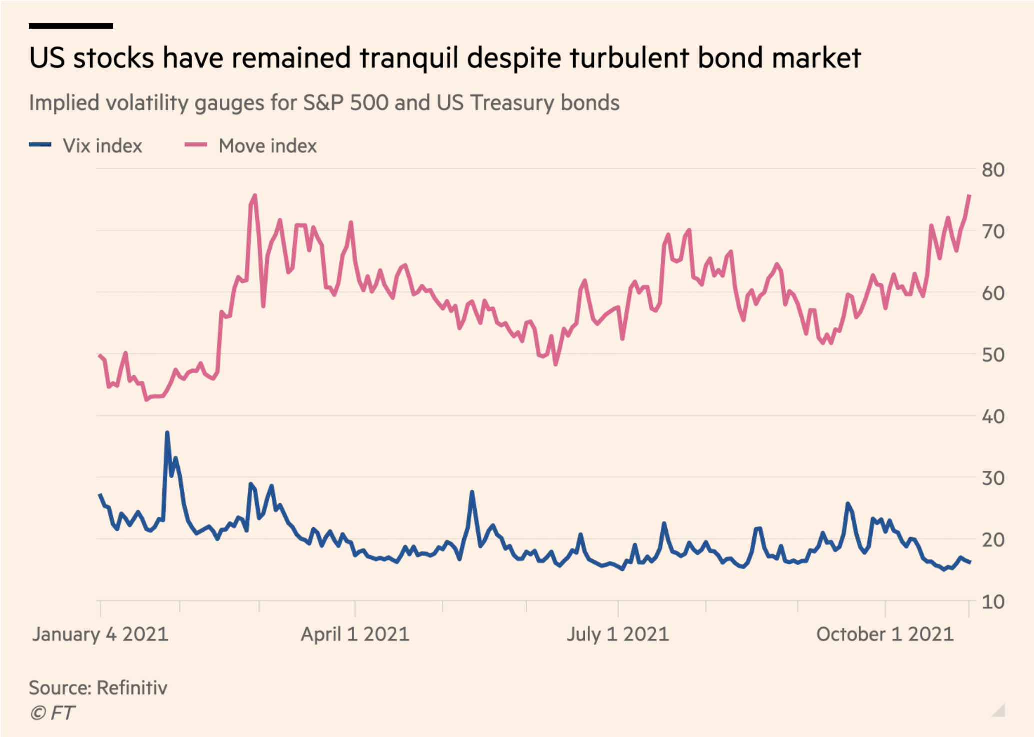


Source: Refinitiv Datastream

Conclusion on inflationary pressures

If inflationary pressures are building, and not easing, then the Fed, along with other central banks will need to respond by tightening. Printing less cash to buy government debt is not going to reduce inflation (tapering), it is just adding fuel to the fire at a slower rate. Tightening is not tapering. Tightening is a monetary policy move that reduces demand, or demand growth, in order to reduce price pressures. Tightening also needs to signal stronger action if necessary. If markets call a central bank bluff, then the central bank must win the showdown. Credibility is at stake, and without credibility, then there is unlikely to be stable and anchored inflation.

Equity markets are expensive and at record highs



So far all the risk has been felt in bond markets, with equities continuing a fairly stable rising trend. The below chart shows the option market's implied volatility (seen as the market's gauge of risk) for the year to date; bonds at highs and equities at lows. This is a substantial disconnect for an equity market that is built on low interest rates and high growth plus massive liquidity.

So simply put, there is currently inflation and we think that central banks will have to contain this inflation by much higher / faster than expected monetary tightening. This is most likely to lead to rising yields (falling bond prices) and falling equity prices. The falling equity price is predicated on the market being expensive against a very high level of corporate earnings and expected growth. The high earnings growth and low inflation assumptions are not compatible in our view, and inflation is a bigger risk and so growth is likely to be sacrificed.

There have been many times where equities have performed well in a rising rate environment (the reflation trade), and at these times inflation was well managed. The starting point was usually a recovery out of a recession, cheap valuations, and a long runway for earnings growth. We do not view the current set up as a reflationary type trade.

The risks for equity that we don't think are priced in:

- Underlying inflation could get worse from here
- Market has been anchored on a permanently dovish Fed, risk of a Fed moving ahead of the curve
- To stop inflation when supply can't catch up to demand (call it bottlenecks / shortages / stock-outs etc) may require artificially reducing demand by raising interest rates - a recession. The equity market is not positioned for this.
    - The recent more hawkish moves from the market only serve to bring the timing of rate increases earlier, but the overall magnitude of total increases hasn't adjusted to what we view as necessary to control inflation

The key point being you can't have all of the below:

- Fiscal Stimulus and large budget deficits
- Low Inflation
- Low interest rates
- High economic growth
- Printing Cash

There are trade-offs that materialise over time, the US, and many developed economies, have escaped from a horrible covid induced recession by bringing forward spending financed by printing cash. This is not a base from which to grow, but a bill to pay off.

Positioning and Outlook

The inflation impacts are building, and short to medium term inflation uncertainty and upside risk is increasing. Markets haven't reacted a lot to the recent news, and for now the signs of trouble are clear but coming through in more subtle ways - eg flattening bond yield curves, falling yields on the long end, increased volatility of bond yields, economic forecasts and in hard economic numbers. A strong US earnings season is currently supporting markets, but the risk is that this is the last good earnings season for this cycle. Over time, higher corporate taxes, higher interest rates, lower demand growth, rising wages, increased difficulty in passing on cost increases will weigh on corporate profits.

Inflation pressures are building and uncertainty (risk) increasing. Markets are ignoring the risks.

Markets are still priced for perfection, but the storm is clearly on the horizon. That being said, and winding back to the beginning of this note, risk is about probabilities and not certainties. Sometimes other unexpected events occur and change the outlook, sometimes very good policy decisions work their way through to managing the risks better than expected, and we could also just be wrong.

Markets are priced for high earnings growth with no inflation - you can't have both given the stimulus is a common driver.

The major counterargument is that running high inflation is fine, noting this is a very different argument to 'there is no inflation', we are circumspect about this. Inflation is fine if the economy is built for it, but we see fragility after: a 30 year bond bull market, economies built on massive budget deficits, major income and wealth gaps, consumers and businesses used to very low borrowing rates, global deflationary forces, underfunded social security and pensions and ageing demographics, high equity valuations and long term bond yields priced for no / little inflation on 20 to 30 year views.

Developed markets are not structured in a way that can accommodate higher inflation and loss of central bank credibility - we expect substantial intervention through higher and quicker interest rate increases.

The other reason we remain circumspect about simply adjusting inflation upwards, in the context of the US, why 3%, why not 4% - where will the Fed's credibility come from? The great invention of Inflation Targeting has been a major economic success story, but it is built on central bank credibility and anchored inflation expectations. If both of these factors are sacrificed in order to adjust inflation upwards more permanently, what will be the force that keeps inflation at this new level?

So looking forward we see these major risks as too high a probability to ignore - and we think it is best to be positioned to avoid the impact of inflation. It is moving slower than we expected, but we see the data as broad and supportive of our view.

Fund Positioning

Generally the funds are positioned for rising bond yields and falling equity prices (on an index level). With local (South African) positioning for a weaker Rand, a recessionary type economy with a weaker consumer going forward. South African bond yields most likely increase as global risks play out, but given the current yield we view them as a reasonable investment alongside our cautious positioning {side note: SA bond duration has been substantially reduced in the fund since the last Rezco Webinar}. Global exposure is positioned with negative duration and hedged equity exposure.

The funds should perform well if markets start pricing in lower economic growth / higher inflation, higher tax and input costs, rising interest rates, lower fiscal support (as central banks pull back on bond buying, budget deficits no longer as easy to fund). We are positioned for falling equity markets, but would also perform well in a sideways market but with rising yields. Equities are positioned more defensively and with a value bias.

The funds should perform well in a rising yield / higher inflation environment. Falling equity and bond prices are expected, and the funds are positioned to avoid significant losses in a market correction.

The same macro view informs the Rezco Equity Fund, which is positioned for a weaker Rand, lower SA growth than expected alongside a weaker SA consumer. The Fund is also positioned with a low beta (which in turns means a very low mining exposure) given our view around substantial equity market risks.

Thanks

While we certainly don't like underperforming markets or our peers over 12 months, we consider our cautious positioning as the correct response to the current macro environment. It is taking longer to play out as we would have expected, but pressure in the macroeconomic space appears to have substantially built and we remain of the conviction that short term risks are very high. As discussed prior, these types of market bubbles take a high toll on the emotions of investors, sometimes the ride up is exhilarating, or the fear of missing out too much. We take firm responsibility for the management of our clients' hard earned savings, and do not take underperformance lightly. That being said, we also see it as our responsibility not to get caught up in the emotion of a market such as the one we are in, we have made our asset allocation calls with clear and focused thought, through our tried and tested investment process and philosophy.

We sincerely thank our clients for their trust in us, and also for remaining on this journey through the cycles. We remain focused on the job at hand - delivering risk adjusted returns to our clients.

ROB SPANJAARD
Chief Investment Officer

SIMON SYLVESTER
Co-Portfolio Manager