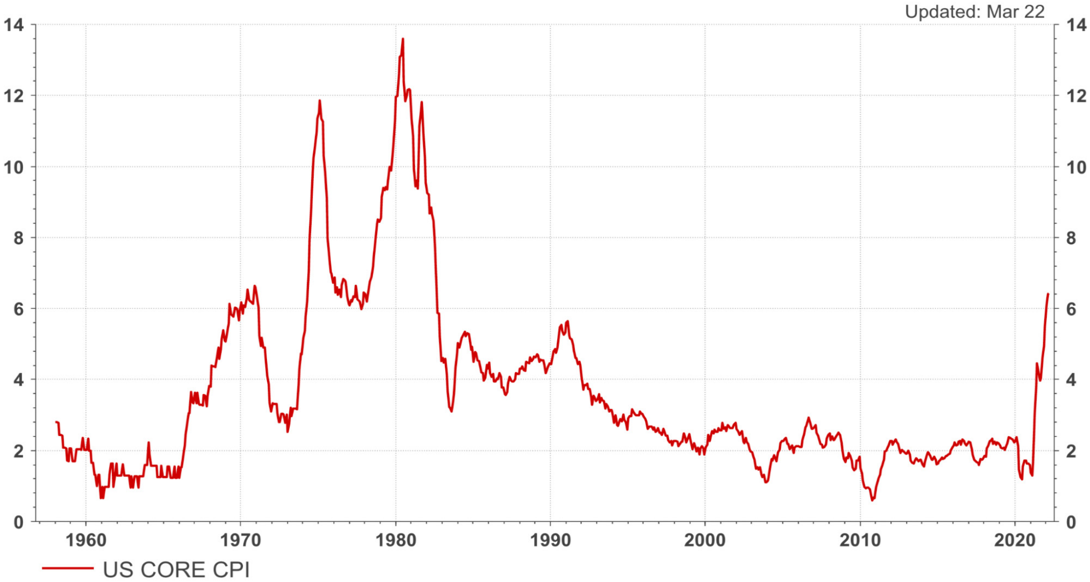
APRIL 2022 REPORT

REVIEW OF POSITIONING AND PERFORMANCE

Broadly speaking, the Rezco funds have been positioned over the last year for increased risks of rising inflation and thus also monetary policy tightening and weak equity markets. This has been a pain trade through the year, but the positioning is now starting to work for the funds. The reason for our incorrect positioning is that we didn't think central banks would let inflation get so far out of control (against their mandate), but this also means that the risks have now increased.

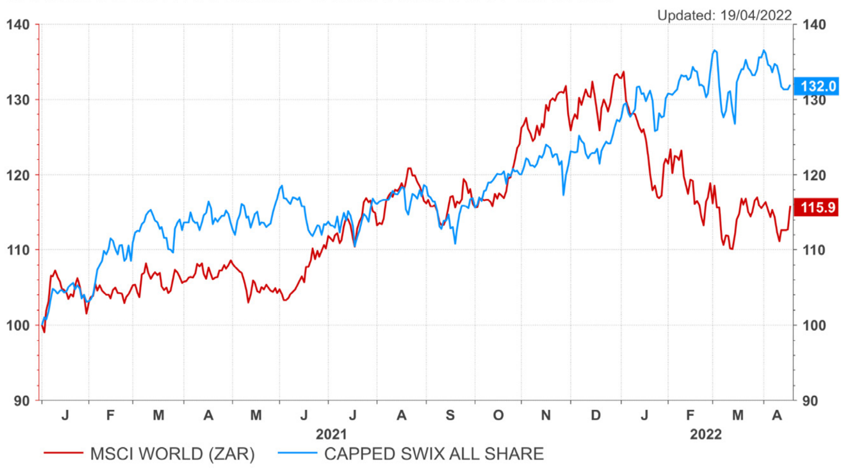
INFLATION HIGHEST SINCE PAUL VOLCKER GOT IT UNDER CONTROL



Source: Refinitiv Datastream

South Africa has disconnected from global markets, not due to any positive structural reforms but simply due to the economy's linkage to global commodity prices. Commodities have been beneficiaries of the excessive liquidity and stimulus globally, and indeed also from potential shortages of supply out of Russia / Ukraine. While this has been a short term boost, commodities are cyclical and risky, and a global tightening of conditions and pockets of recessionary conditions suggest commodities will give back most of their recent gains. South African asset values are thus being propped up by a very fragile foundation. Investing in SA assets implicitly relies on continued support from global liquidity, counter to how the multi trillion dollar global bond market is pricing for the global liquidity and monetary policy risks. Ultimately we see SA asset prices reconnecting with their long held linkage to global risk assets into a bear market.

SA EQUITIES OUTPERFORMING GLOBAL EQUITIES BY OVER 15%



Source: Refinitiv Datastream

The debate on inflation has largely been resolved: Inflation is very high and very broad. Risks are still to the upside in the near term. The idea of supply chains quickly easing has been replaced by concerns around war and Chinese lockdowns. 'Just in time' inventory management has moved to the less cost efficient 'just in case'. The benefit of globalisation and production efficiency has been replaced with higher cost localisation and concerns on geopolitical risks and certainty of supply. Energy costs are permeating and seen clearly through massive producer price increases in Europe in the 30%-40% range, the US is not as impacted and only has about 10% producer price inflation. Rent inflation and general costs of housing are still to come through in the inflation prints, and the expected cost increases in food are scaring economists and politicians alike.

The debate has moved from whether inflation is transitory or not and now revolves around what it would take to get inflation back towards target levels. In Europe the monetary authorities have been more cautious, but the financial markets are nevertheless moving ahead and repricing. The data is clear. As far as equity markets are concerned, the focus should be on the USA. The central bank in the US (the Fed) has pivoted from not worrying about inflation to becoming highly concerned, with some members and commentators a little panicky.

Here is how we are reading the current consensus view of the Fed, and arguably also the view built into equity markets (but not bond markets which have sold off rather dramatically):

- Inflation is high now and needs to be brought under control.
- Past inflation has been propped up by external commodity price impacts and past shortages (e.g. automobile price increases). There are thus very high base effects in the inflation numbers and over time these prices should mean revert to some extent, but at least also reduce new inflation prints off this high base level.
- Some prices are outside the Feds control - food and energy - and should be ignored for now.
- Over time supply should respond (increase) and supply chain blockages should ease to help reduce pressure on prices.
- Fiscal policy is going from highly stimulatory to less stimulatory (a reduction in government spending / support) and this should ease price pressures.
- Inflation expectations over longer time frames are reasonably anchored, so people still expect inflation to come back down towards target levels.
- By moving from accommodative to neutral monetary policy, inflation should ease back towards the target of 2%.

Overall the Fed is hoping to engineer what is called a soft landing, this is reducing inflation to target without causing a recession or a big increase in unemployment. The Fed's economic projections[1] are showing inflation falling to 2.3% in 2024, economic growth slowing down but remaining slightly stronger than long run (normal), unemployment staying at these low levels and interest rates moving to neutral levels. The US Treasury Secretary and ex Fed chairman recently made the comment that the Fed would need luck and skill to execute to their plan, an ex voting member of the Fed has called a recession inevitable[2], and a voting member of the Fed has called the idea of a soft landing, fantasy[3].

1 https://www.federalreserve.gov/monetarypolicy/fomcprojtable20220316.html

2 https://www.bloomberg.com/opinion/articles/2022-03-29/is-a-recession-coming-the-fed-has-made-it-inevitable?sref=pp5WIoMA

3 https://www.ft.com/content/e759c33f-2515-4269-8c9b-e9e517d22a3d "There's a bit of a fantasy, I think, in current policy in central banks," Bullard said in an interview with the Financial Times. "Neutral is not putting down-

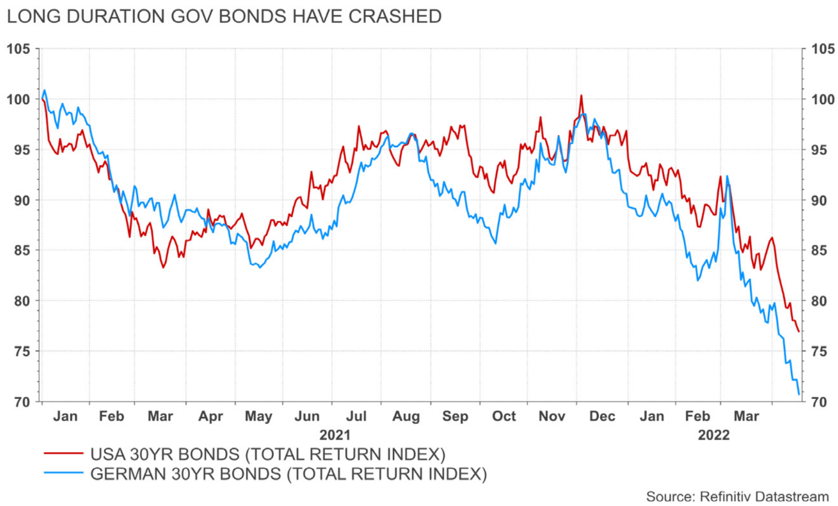
The idea that inflation will come under control from such elevated levels, through a period of continued supply disruption while maintaining strong economic growth, without any tightening from monetary policy[4] is more simply just a fancy way of saying that inflation is still transitory - it will revert towards target by the mere removal of stimulus. So the Fed may have retired the term transitory, but it lives implicitly in their projections.

How does this all work out? We don't see continued inflation into the next 1-3 yrs but rather a high probability of a recession due to tighter than expected monetary policy. Simply put we don't think the Fed has abandoned their inflation targeting mandate, they made a policy mistake and will correct as more data and time unfolds. Fed commentary supports this view even if their current economic projections suggest otherwise. This means inflation comes under control due to tightening, this will be bad for company earnings, valuations and ultimately equity prices. In bond markets, however, a lot of the pain is already in the price, but there could be further downside if inflation expectations lose their anchor.

Relying on Fed forecasts is unreliable, rather it is their mandate and the economic data that we see driving their actions. Indeed the Fed chair made it clear that their published projections should be used with caution, noting how wide the dispersion is between individual members' projections - uncertainty is extremely high but the one area where there is very clear consensus is that the inflation risks are all to the upside.

POSITIONING FOR SUBSTANTIAL GLOBAL RISKS

Bond markets are panicking but equities have yet to correct. We agree with the bond market- inflation risks are substantial. There are multiple risks currently which concern us and don't appear priced into equities correctly:

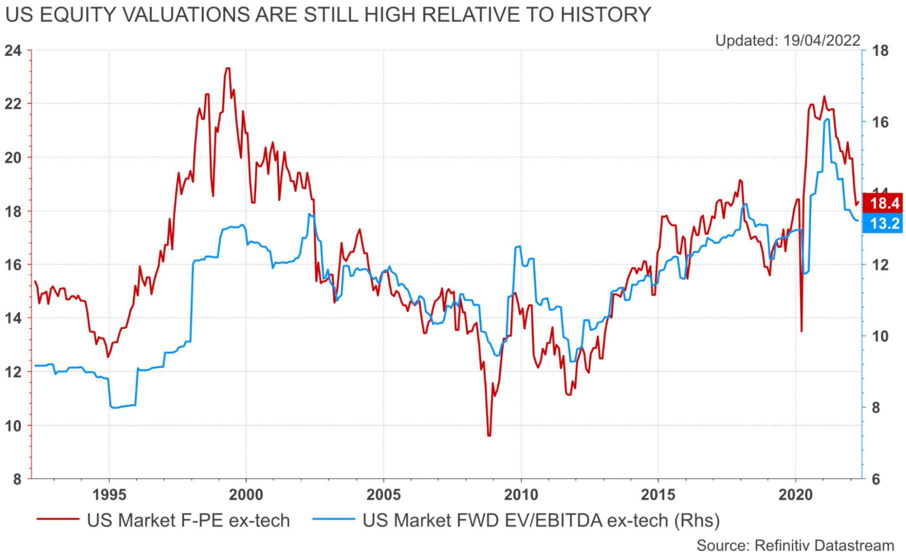


- Inflation
  - » The risk here is the monetary policy response (tightening).
  - » Near term conditions are adding inflationary pressures (supply chains, war, lagging impact of sticky price inflation, especially rent).
- Covid lockdowns in China.
- Drawn out Russia / Ukraine conflict and further related geopolitical risks.
- Continued political risk in South Africa leading into the ANC elective conference.
- Continuity of energy supplies into Europe.
- China growth and managing their housing sector risks (how to soft land the extreme price and volume of the housing sector).
- Falling consumer confidence, most notably in Europe.

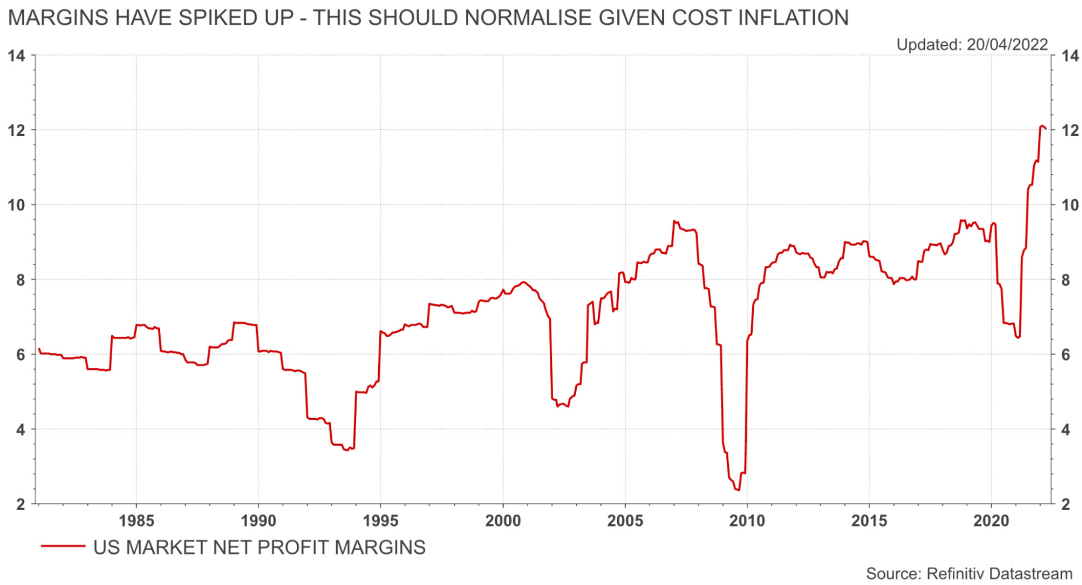
ward pressure on inflation. It's just ceasing to put upward pressure on inflation."

4 Another view would be that the economy is so fine tuned for low interest rates that it would not require much tightening to cause a recession - and thus ease the inflationary pressures. In other words, in attempting a soft landing through more measured rate increases a recession is caused anyway, but earlier than expected.

Some of these risks are interrelated, notably some supply risks adding upward pressure to inflation. The core of the problem is that these risks are all substantial, with interlinking probabilities which increases the joint probability of a negative event. These risks are largely being ignored in equity prices at an index level. While it is possible for these risks to dissipate and resolve somehow, currently high equity valuations give us strong convictions that now is a bad time to own risk assets. These risks individually could cause a substantial correction (note some examples follow in the next section), and collectively they can cause a major bear market or even a crash.



Valuations may not look so extreme[5], despite being much higher than pre GFC and similar to the Dot Com bubble, but it is important to note that corporate margins are extremely high. We expect currently high margins to decrease substantially due to cost pressure, a weakening consumer, rising interest rates, and companies struggling to pass price increases due to the consumers wallet being under pressure given food, energy and interest increases. The forecast earnings do not have margin pressure to the extent we expect, and thus the valuations are flattered in the above chart.

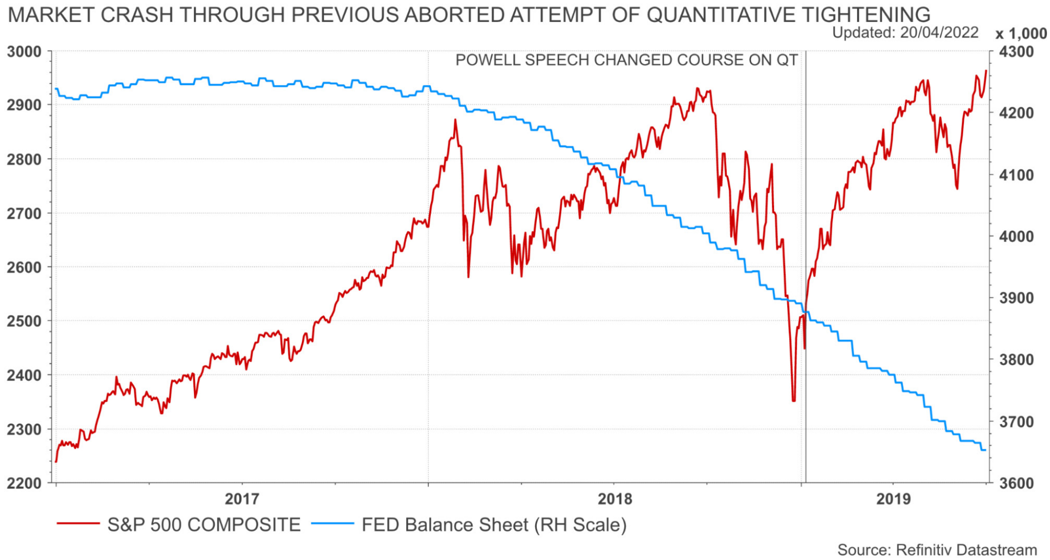


LESSONS FROM PAST MARKET MOVES

The last time the Fed tried to shrink their balance sheet:

The Fed tightening was one of the risks mentioned above, this risk on its own caused the below market correction. Interestingly the market reaction was so severe that the Fed reversed course on their Quantitative Tightening road map - this is often referred to as the Fed Put. This is the idea that if markets react too negatively the Fed will want to help prop markets up. There is, however, another idea debated now called the Fed Call - the Fed actually wants markets to fall to help ease the inflation pressures and help do the job that interest rates can't do in the short term.

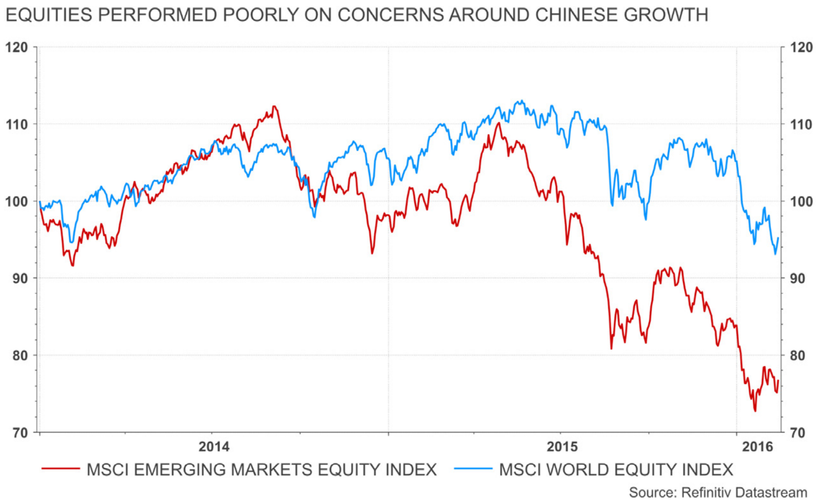
5 Tech is excluded in this chart due to the extreme move over the dot com bubble



Note: The Fed could bail on QT last time as there was no inflation then, the option is unlikely available now even if equities crash. Also note that the above drawdown was with much slower reductions in the Fed balance sheet; it is expected that the new tightening cycle will be at USD 95bn / month increments.

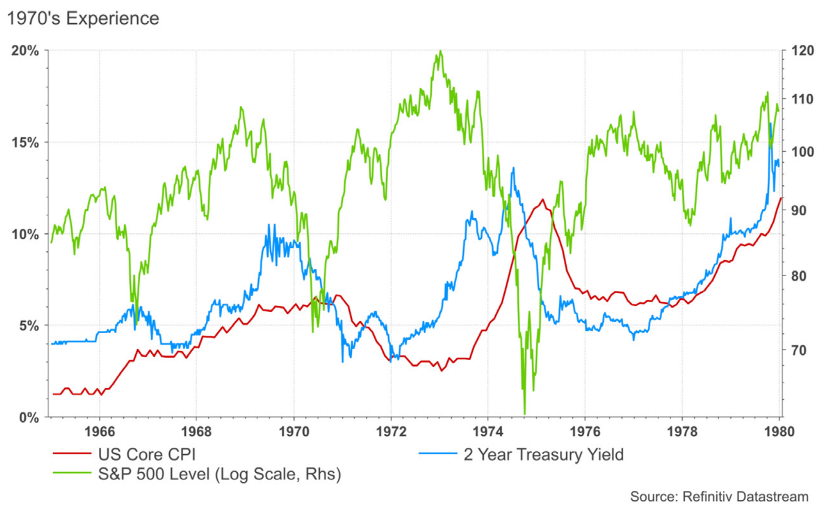
Last time the world was worried about Chinese Growth:

The Chinese housing bubble was another single risk mentioned above. China is a major economy, the last time the market was concerned about Chinese economic growth saw US equities have a decent drawdown, and emerging market equities entered a bear market. This was resolved, like most other equity market corrections since the GFC, with more stimulus and China effectively kicking the can down the road on their housing issues. With all the risks in the news, it is easy to forget the Evergrande headlines that now seem outdated.



Equities performance when the fed was behind the curve in tackling inflation:

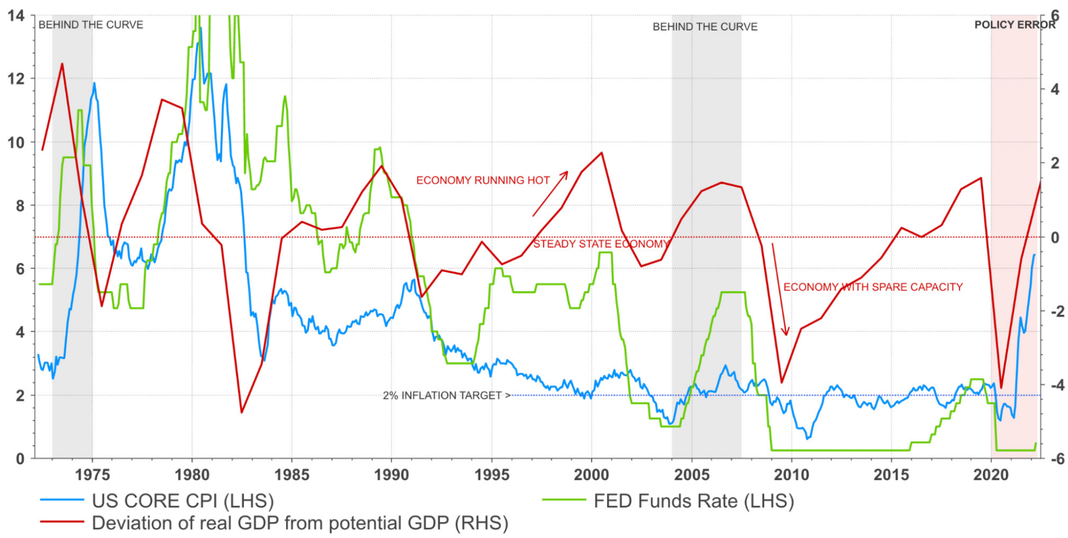
Tackling inflation using the blunt instrument of monetary policy very often is negative for the economy and equities - there have indeed been some soft landings but they are the exception. The below shows the ~50% drawdown of the S&P through the 1970's. It's dangerous to focus on a small sample of events that support our view, but what is important for us is understanding the mechanisms that drove this - these mechanisms appear similar today except Quantitative Easing and Tightening is currently a major force that was not present then.



THE FED IS NOT BEHIND THE CURVE - THEY HAVE MADE A POLICY ERROR

A lot is understood about economic cycles, and indeed investing through the cycles for long term growth is often stated as core to long term portfolio management. If this was merely an economic cycle playing out we would then be positioned too cautiously in the funds. Rather, the Fed made an inflation forecast last year that turned out to be horribly wrong. They are now incorrectly positioned by the widest margin in their history, and they need to correct it. To make matters more difficult there are external impacts on the cost of goods making projections even more difficult.

The below chart shows economic cycles, the Fed's policy rate and inflation - there were times the Fed was behind the curve - e.g. leading into the GFC interest rates were hiked substantially and offered high real interest rates - they were still behind the curve then and a housing bubble built and then blew up. The 70's are well noted as a period the Fed was behind the curve; not aggressive enough on their monetary policy to control inflation, and making many excuses that the inflation was just due to one off price increases in specific items[6]. When comparing these periods of the Fed being behind the curve to the current period, there are a few similarities. The Fed stopped printing money last month. Interest rates we just lifted off zero. The positioning was relying on inflation being transitory, and thus they have allowed a massive gap to emerge. Closing this gap would be too damaging to the economy, as John Taylor (the inventor of the Taylor rule used globally by central banks within their interest rate policy setting) notes - interest rates should already be at 5%, but this is not possible, so he proposes getting to 3% by year end with hawkish signaling[7].



Source: Refinitiv Datastream

WHY NOT BUY EQUITIES - THEY ARE THE BEST INFLATION HEDGE?

This argument appears based on the idea that when there is inflation it is better to hold real assets that can go up, and in some past cycles some risk asset prices have performed well in the early stages of tightening. Our key concern is that we think the Fed, and other central banks, are going to counter inflation by tightening very aggressively - some already are. Tightening policy is bad for company earnings, consumer confidence and economic growth. Investing in equities in a worsening earnings, growth and consumer confidence cycle is usually a bad risk to take. The key point is that in prior cycles the tightening was pre-emptive and into a strengthening economy.

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6 https://www.project-syndicate.org/commentary/fed-sanguine-inflation-view-recalls-arthur-burns-by-stephen-s-roach-2021-05

7 https://www.wsj.com/articles/inflation-jobs-fed-recession-economy-11650294297

There were still some good years left. This may not be the case this time as inflation has been allowed to go out of control and needs to be reigned in quickly else risk more substantial consequences. Central banks know this, and have stated their intention not to let this happen. The economy is strong now, but built on negative real interest rates, this fragility is a key risk and sensitivity to positive real rates is unknown.

Now if our view was that central banks would let inflation just run rampant, then by all means avoid bonds and cash and buy real assets. This is not our view; inflation will get reigned in as it is well understood that the consequences of uncontrolled inflation are much worse than the consequences of tightening monetary policy.

MULTI ASSET FUND POSITIONING

Internally we have a view that there is always a good investment opportunity staring at you in the face. We always need to be on the lookout. Currently we see hedged equity as a good opportunity, and where we can, the funds have a good allocation to this asset class. We are working hard on buying global equities with upside opportunities (or at least more defensive should the market fall). The funds then use hedges, mostly put options on the S&P 500, to protect against downside risks.

Globally we are currently seeing some themes with upside opportunity

1. New Inflation Hedges

The structure of the economy has changed since the last time there was inflation, as new industries or industry structures have emerged. For example, we see content, communications and technology platforms potentially as a new inflation hedge. The core ingredients of a good inflation hedge are:

- Inelastic demand
- Paid for asset base
- High margins and cash generative

As an example, a music label owns a library of music content. The asset is largely already paid for but the value should inflate with prices. Similarly, one could argue some technology is largely paid for through wages / coding - for example Microsoft Office. Broadly speaking, technology companies with subscription based revenue models for already built assets could perform well through an inflation cycle. Long duration assets (in which all tech seems to be bundled into) have been performing poorly as interest rates have been rising, and hence we think these opportunities will emerge over time - the share price still matters.

2. Commodities (Old inflation hedges)

There has been much talk of commodities being historically a good inflation hedge, notably energy (oil) and gold. The world has changed since the last inflation cycles, and we see other inflation hedge opportunities that don't have the cyclical risk that commodities do. That being said we do have some commodity exposure, especially those that supply commodities where Russia / Ukraine are large global players. The commodity allocation within the funds have generally performed well, especially within the global allocation. We have been reducing exposure here throughout the funds.

Our concern is that globally asset managers, now worried about inflation, have crowded into this consensus trade. We don't have a high enough conviction that commodity prices can hold up at these elevated levels through a tightening cycle. Cost inflation and volumes are also a concern for mining equities. If the crowd all tries to exit at the same time there could be substantial drawdowns in this sector.

3. Higher yield beneficiaries

Banks and Insurers generally benefit from higher yields. Banks can be exposed to the economic cycle and thus warrant caution.

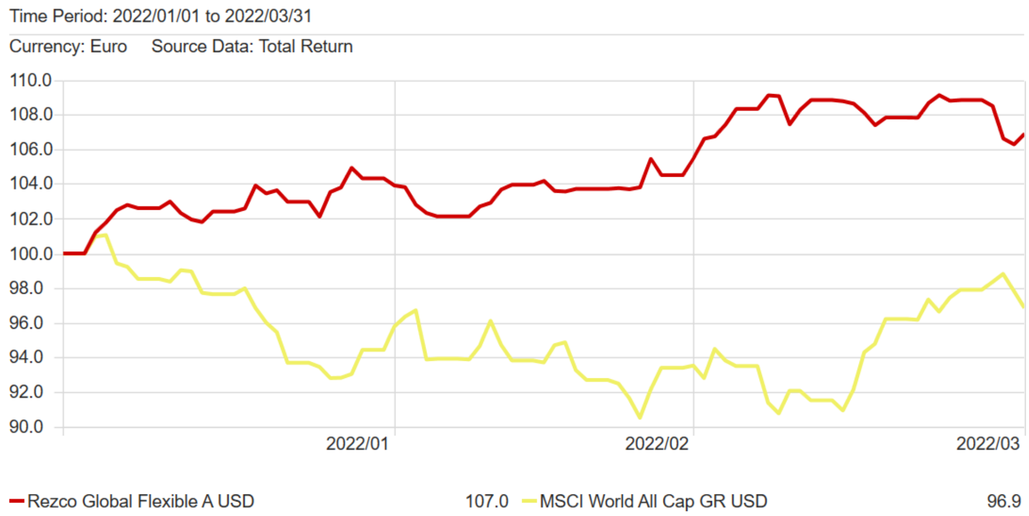
4. Defensive utilities and REITS

We have invested in defensive shares against S&P 500 put options (making sure to select a well priced basket of options). The idea here is that if the market corrects, the combined strategy should perform well, but if the market keeps on ticking up from here, the profit from the shares should help fund the option cost.

5. Machine Learning Strategy

Our machine learning tools are adding value within our process. These signals on their own are proving to outperform the market (tracked on a paper portfolio), and we then conduct research and select shares from this list for inclusion in the portfolio (tracked as a traded portfolio). Feel free to ask for more information on what we are doing in the machine learning space.

Overall, the hedged equity strategy has been performing well year to date with the Rezco Global Fund ticking up gradually without taking a lot of risk. While this is a short period, and is after a period of under performance, it is worth noting that the market only became concerned about inflation with the release of the Fed minutes in early January this year. The period is short, but it is the full period of a market struggling to price the inflation risks.



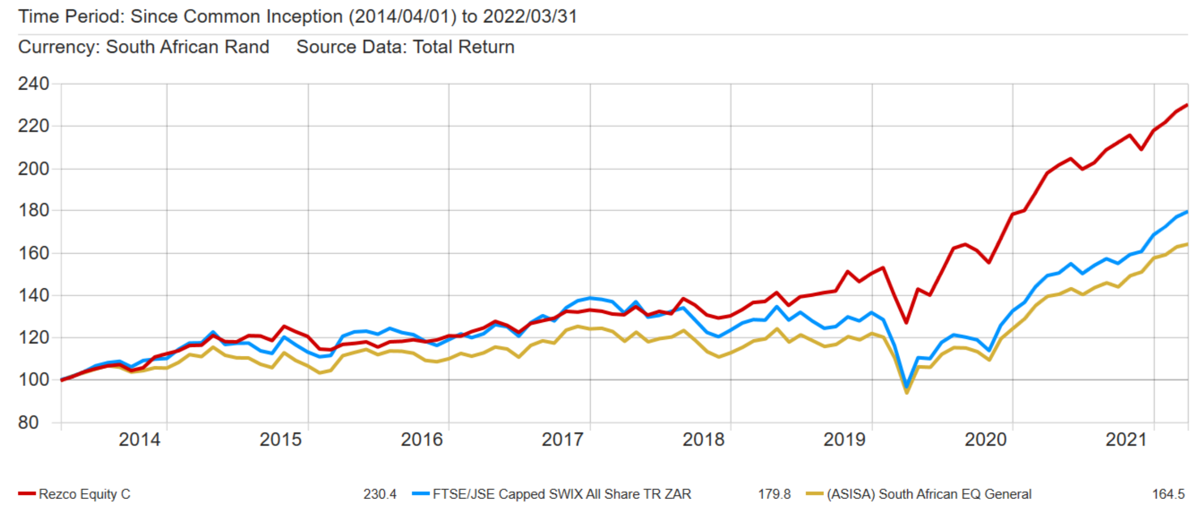
Source: Morningstar

Locally the positioning is more cautious:

The reason is the disconnect between SA equity prices and global prices. Commodity prices permeate the whole economy: it is not just mining companies benefiting, but the SA trade balance and Rand, SA tax collections and social grants, SA Inc companies supplying into the industry and enjoying the widespread benefitts of the tax / earnings / currency windfall brought about. We think it is too risky now to own SA assets, and thus the local multi asset funds have reduced exposure to SA equity substantially.

All the funds have very low, or zero duration (long term bonds) exposure. The decision on SA bonds is more difficult, but ultimately the drawdown risk is more immediate than the benefit from fairly robust interest rates. We think there may be a good point to re-enter the local bond market, but current conditions suggest caution. We see all SA assets as risk assets - the currency, equities and bonds. We are a small emerging market and we expect the economy to ultimately be tossed around (as generally is the case) with whatever is transpiring globally.

REZCO EQUITY FUND



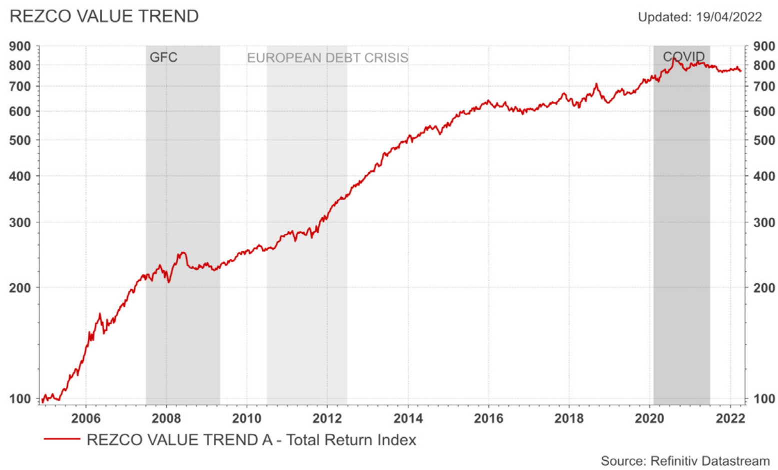
Source: Morningstar

The performance of the Rezco Equity Fund has been in line with the strong equity market recently - after a period of solid out performance. We are pleased with this performance given that the fund has been taking much lower risk over the period as it has largely been positioned more defensively given our macro views. Stock picking, a focus on portfolio risk management, and staying active by rotating between sectors and trading shares that have moved too far has helped maintain good returns while keeping portfolio risk well managed.

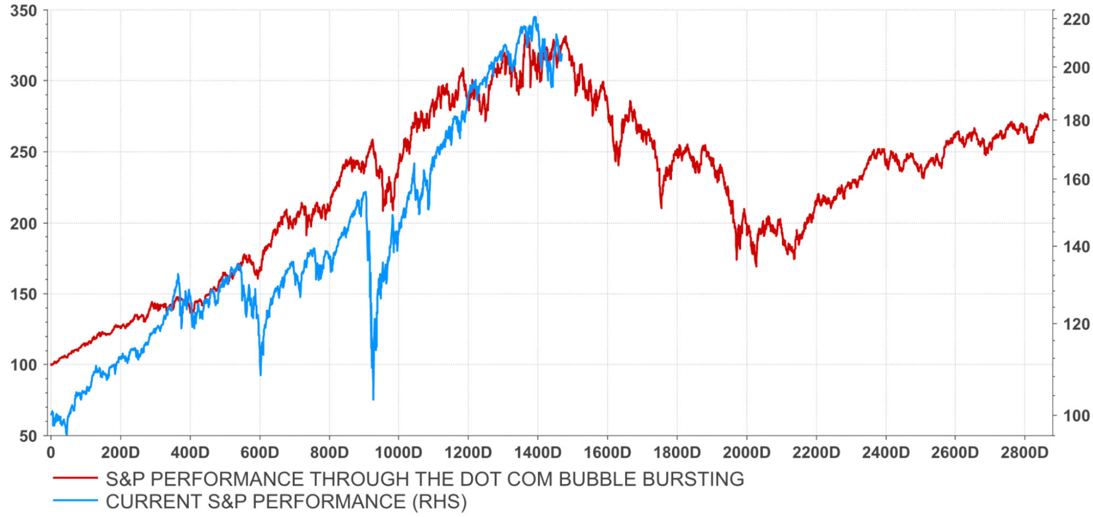
Currently the fund has increased the defensive positioning through increased global diversification (as best available via the JSE listed opportunity set) and reducing exposure to cyclical companies - the Rezco Equity Fund is well positioned for a market correction while staying fully invested.

MANAGING THROUGH A CRISIS

The last year's performance has been disappointing for the Rezco team, but we have confidence that we are correctly positioned for the unfolding macro economic environment. As per the chart, we have a good track record of managing money through a crisis. Indeed, we want to take risk when we see it as a good time to take risk, such as the perceived European debt crisis that never really materialised, but are also willing to take risk off the table when the market is not sufficiently concerned (asset prices are high and not factoring in the risk). We see risk asset prices currently as substantially mis-priced- similar, if not more so, than pre GFC and pre covid. This is not a market timing call; the risks are clear to see. We don't know when markets will fall, and they may not, as nothing is certain. The probability of making positive returns here appears very low, but we see the risk of capital loss at an extreme high. It is worth noting, as seen in the chart below, that market tops are never clear at the time, they only become clear after the fact. Substantial patience and conviction is required as the market works through this volatility, and risks become clearer and get priced.



MARKET TOPS TAKE TIME TO WORK OUT



Source: Refinitiv Datastream

While we were too early in exiting the market last year, the risks are now larger. For those that have benefited from the strong equity markets, it is our firm view that now would be a good time to take those profits and position more defensively. The Rezco product range offers a good place to hide for now, but also offers the flexibility to invest rapidly should the opportunity arise.

As always we are grateful to our clients for their support, especially during what has been a tough pain trade and under performance of our multi-asset funds. We are working hard to produce excellent risk adjusted returns for our clients through what is expected to be a very volatile and risky market over the near term.

Simon Sylvester
Head of Research & Co-Portfolio Manager

Rob Spanjaard
Chief Investment Officer & Executive Officer