REZCO

REZCO'S VIEW OF THE EQUITY MARKETS FOR 2022

At the start of 2021 our investment team became extremely concerned that the amount of stimulus being thrown at the world economies was out of proportion to the economic effects of the Covid related slump of 2020.

2021 was a difficult year for our Balanced Funds, given that we positioned largely risk off for the year, with the Funds being positioned to benefit from the market having to reprice risk during the year.

WHY THE RISK OFF POSITIONING IN OUR BALANCED FUNDS

We were especially concerned that continued aggressive stimulus to a world economy that was already very hot, would lead to inflation. **Since the world equity markets were already overvalued, once the central banks started to rapidly tighten economic conditions, equity markets would have to reprice.** The timespan for this would be compressed because, in prior cycles, the Central Banks would pre-empt inflation and tighten well before any inflation got going. This cycle, the Fed changed their stance to wanting to see actual inflation instead of pre-empting it, so that the peak and fall in market valuation levels would be a lot closer to the timing of interest rate increases.

WHAT HAS THE BULL MARKET BEEN BUILT ON

Much of the elevated equity valuations of the past two years have been built on three core pillars.

Firstly, there is no alternative to equities and risk assets, coining the acronym T.I.N.A, since interest rates were expected to stay near zero until 2023.

Secondly, "Cash is Trash" due to the money being printed. Any suggestion of Central Banks having to mop up some of the Quantitative Easing "QE" or Money Printing, based on past experience, would not have to be considered until at least 2025. Consequently, too much cash floating around would continue to drive up asset prices.

Thirdly, Corporate Profits would continue to grow strongly, driven by the extremely stimulatory financial condition facilitated by QE and zero interest rates.

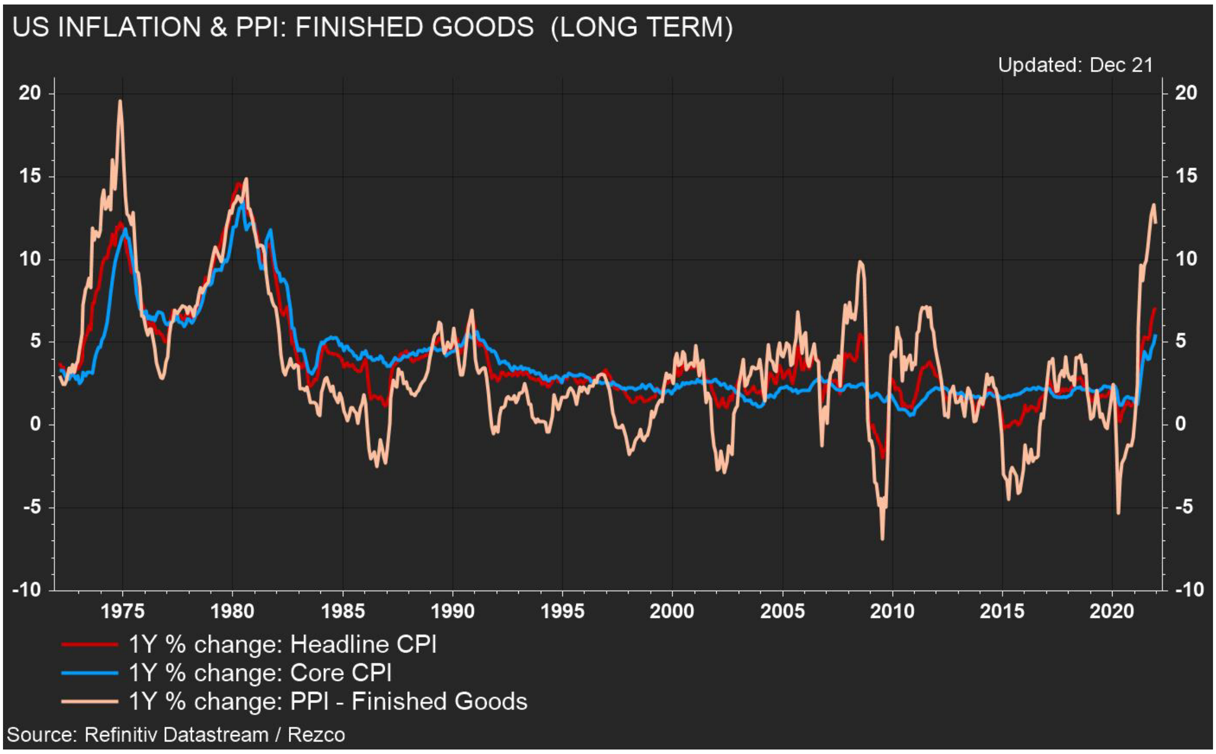
We detail lower down why we are of the opinion that these central pillars supporting the edifice of the current high equity values are being removed.

2021 & SLOWLY BEING PROVED RIGHT

As detailed by the famous economist John Maynard Keynes, to paraphrase: 'Markets can stay irrational for a surprisingly long time'.

One of our core investment philosophies at Rezco is that one can, and sometimes must, change one's opinion and positioning as new facts emerge or when one realises that one's interpretation of the current facts is incorrect. As 2021 rolled on, the facts seemed to be backing up our core thesis. Reported inflation was accelerating and so were inflationary forces. Amongst the many data series that we follow closely, two really stood out. Firstly, the quits and job opening rate was indicating that the USA was already very close to full employment. Secondly, the degree that consumption and thus supply of goods was running at about 20% above pre-covid related levels, indicated that the inflation appearing through the year was not purely as a result of supply bottlenecks, but may be as a result of excess demand. The Federal Reserve's own economic survey, called the Beige Book, was full of genuine examples of widespread cost increase pass through.

Many experienced economists and market commentators such as Larry Summers and Mohamed El Erian were issuing shrill warnings about inflation. Wanting to avoid gravitating to opinions that agreed with us and thus fall into the well known behavioural finance trap of self-confirmation biases, we looked hard at the counter arguments put forward by people such as Nobel Economics Laureate Paul Krugman. The facts as they rolled out through the year continued to inform our opinion that the inflation camp reasoning was far sounder. What really surprised us and hurt investment performance is how long the Central Banks, and especially the Fed, took to realise that there was in fact real and widespread inflation. As recently as September 2021, the Fed was signalling that they most probably wouldn't increase interest rates at all in 2022. As it turned out the Inflation camp were correct, as the graph below shows. Paul Krugman, who was one of the strongest academic voices in the "No inflation problem" camp, has now gone on the record that he was wrong about inflation and that there is in fact a real problem. At the latest Federal Reserve meetings in January, the Fed made it very clear that they now accept that there is a real inflation problem in the US economy.



SO WHY DOES THIS MATTER

Our clients may well ask why we have been so worried about inflation for the past year and why we are still talking about it. Why does this matter; surely the rosy state of the world economy and all the cash washing around the world financial system means that there is very little downside for financial markets.
Run-away inflation matters because the medicines that are prescribed to cure the ill, based on past experience, have rather nasty side effects for the prices of risk-assets.

The Fed has realised that essentially the problem in the US economy is one of excess demand and not simply a shortage of supply; they are on record as saying that they can do very little about increasing supply but have the tools to reduce demand. Namely, higher interest rates and withdrawing the Quantitative Easing or Money Printing that they have been doing.

In short, the economy is too hot and they need to cool it down. Reducing demand in an economy looks and feels like a recession, and this will reduce company earnings from the very elevated current levels.

The pillars holding the current equity bull market are being removed.

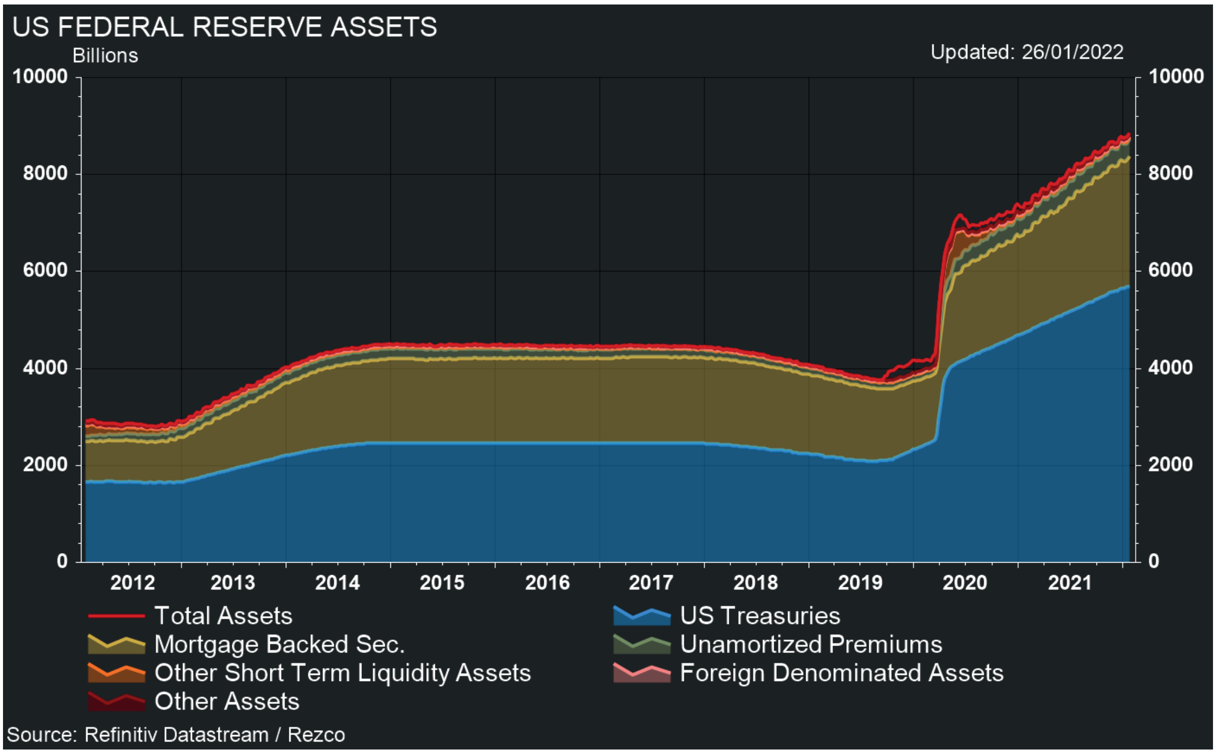
Pillar one removed:
USA Interest Rates will stay low or near zero until 2023.

As recently as October 2021, as the graph below shows, the credit markets, based on the Fed's guidance, were not expecting even one quarter percent interest rate increase in 2022. This has now accelerated to almost 5 increases in this year.

Pillar two removed:
Cash is Trash for the foreseeable future.

The following chart shows the size of the Fed balance sheet. The increase, for those lay people among us, is new money that has been "printed", or Quantitative Easing (QE). This is normally only ever done in times of extreme monetary stress such as in the Global Financial Crisis of 2008 where Fed did QE of about 3,5 trillion dollars. In that case, they only started undoing the QE about 3 years after they stopped the program.

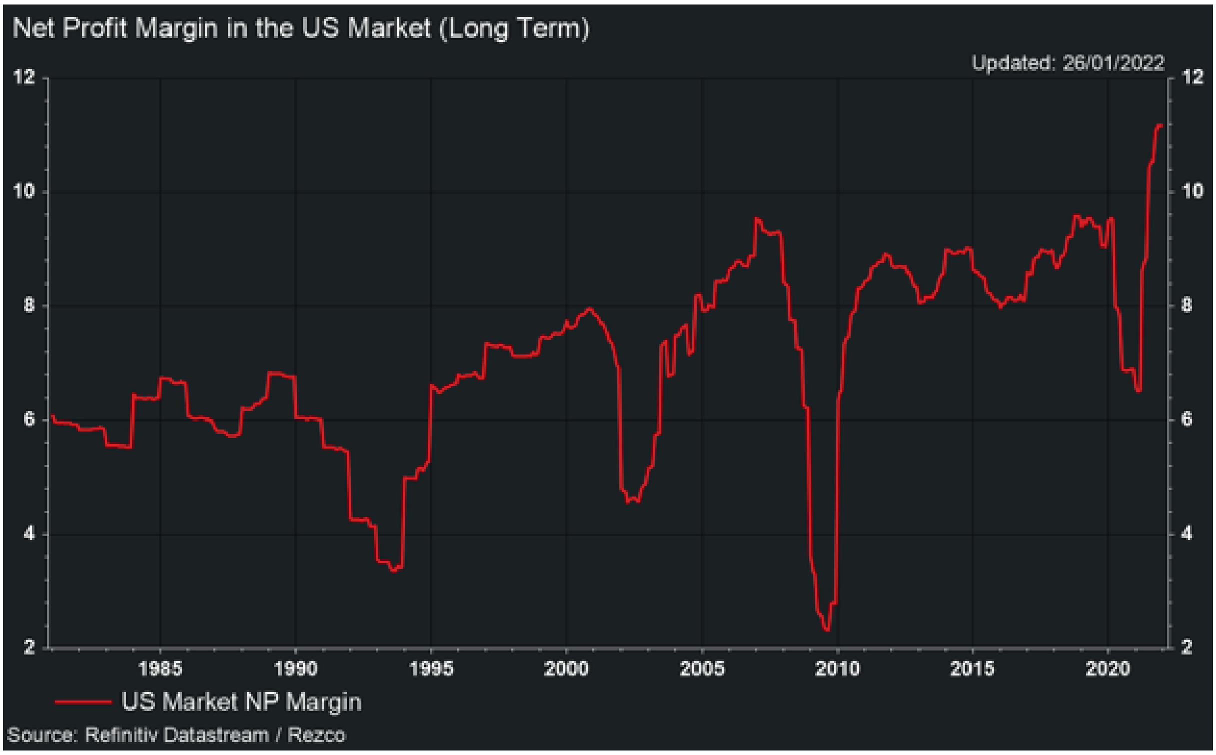
What really shook the markets in January 2022 was the Fed making it known that they were concerned enough about inflation to start undoing the QE only 3 months, not 3 years, after they stopped the money printing program. As can be seen from the chart below the QE this time around has been in the order of 5 trillion dollars. This has been one of the key pillars of the risk asset rally over the past two years.



In 2018, when the Fed last attempted to unwind some of the QE they had been doing, the stock markets had a very nasty reaction, only recovering when the Fed announced that they were abandoning the program of unwinding QE. They had the luxury of doing that then, as inflation was stable around 2%, as opposed to the current 7% and unstable.

Pillar three at risk:
Record corporate profits will keep driving share prices.

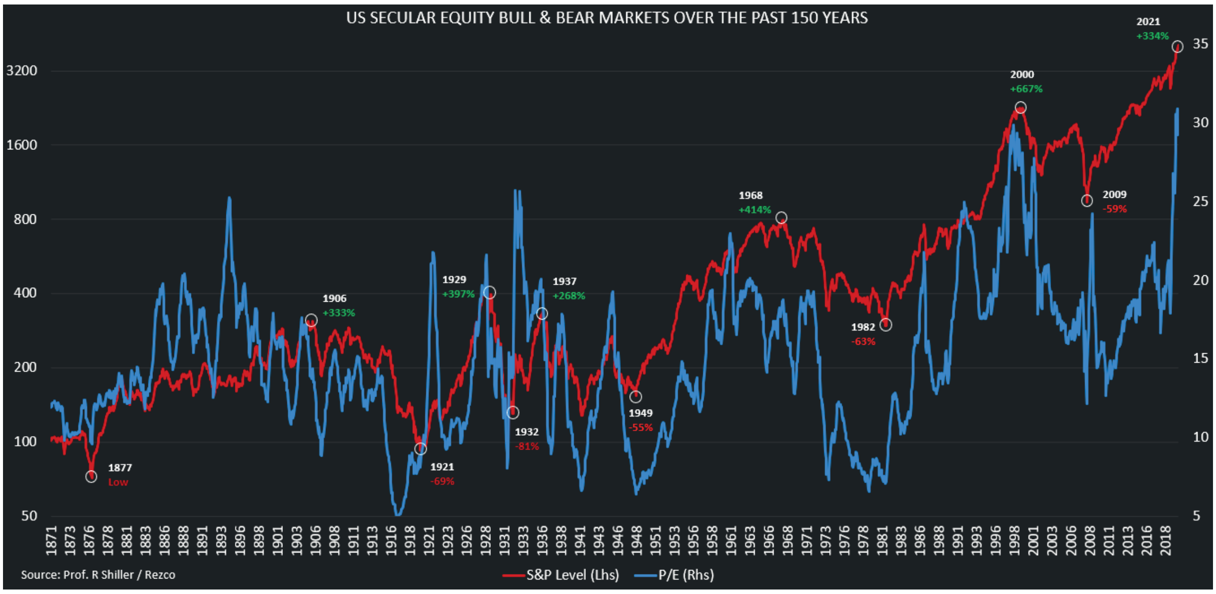
The spectacular corporate profits of the past year have largely been fuelled by the Fed allowing the economy to become overheated. The chart below shows how elevated corporate profits margins have become relative to their historical norms. In tightening circumstances one would expect margins, and thus corporate profits, to contract rather significantly to get back to historical norms.



What is doubly worrying however, is that the Fed are now concerned that one of the core problems in the economy is that demand is too high and they need to reduce it. This at best looks like a subdued economy and at worst looks like a recession. Should the Fed and, incidentally, also the European central bank, have to cause a recession to rid themselves of inflation, corporate profit margins could halve from here.

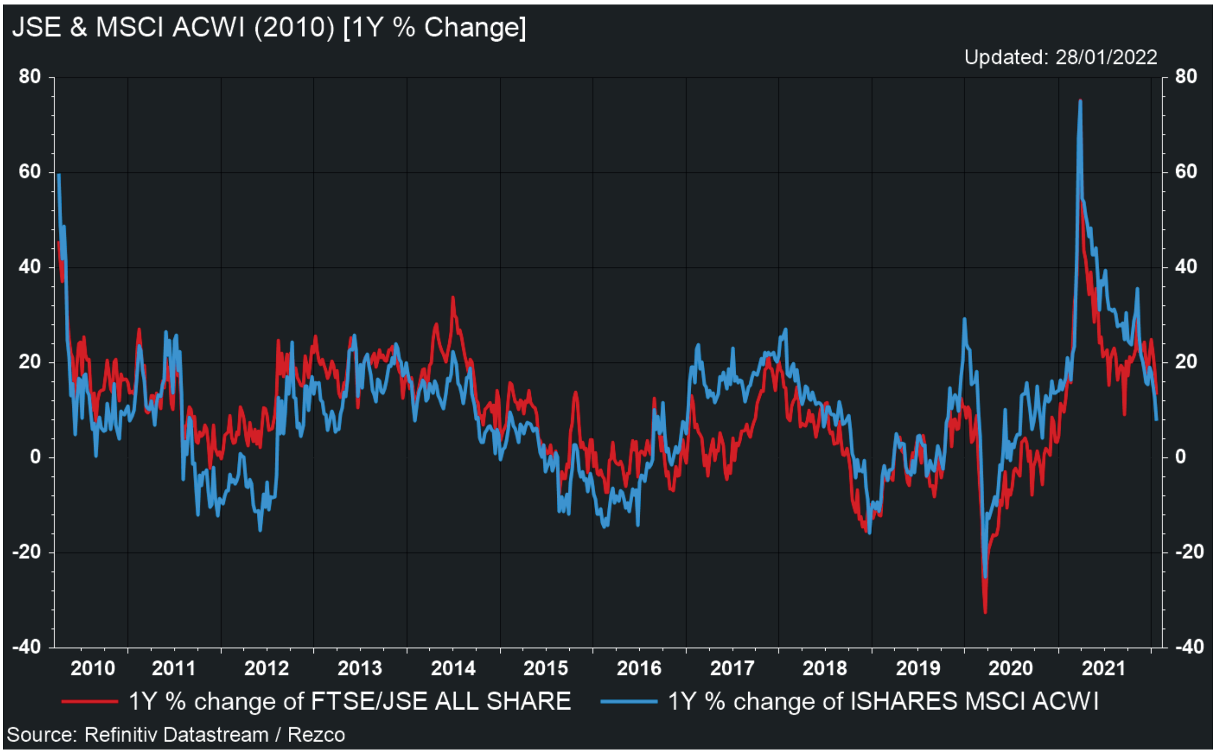
BULL MARKETS AND BEAR MARKETS

Contrary to current popular opinion, equity markets do not always go up, but can have periods when they go down. These normally start from valuation peaks as the graph stretching back over 150 years clearly shows. The down periods that are most toxic have two main characteristics; firstly they start from a place of extreme over-valuation and secondly they coincide with recessionary conditions.



WHY DOES THIS MATTER TO SOUTH AFRICAN EQUITY PRICES?

Clients may well ask why we are talking about international markets when a large portion of their money is invested in local markets. The chart below shows the one year percentage change of the JSE All share Index and the MSCI All Country Index. It is most likely that a large drawdown in international markets will be mirrored by something similar in South Africa.



HOW DOES THIS PLAY OUT AND WHAT ARE THE SOLUTIONS FOR 2022?

The old adage "Don't Fight The Fed" probably applies from here. They have called time on inflation and are clearly going to get it under control. We expected them to do this early last year, and in fact they should have acted way sooner than they have. Nonetheless we are in the tightening phase where they have to restrict economic activity to slow down inflation. Traditionally this has not been a good place for equities. In prior cycles the equity markets have continued upwards as the rate hiking cycle got started. So why the extreme risk off positioning? In previous cycles, the Fed started lifting interest rates in anticipation of inflation and thus had the luxury of slowly tightening as the economic growth cycle matured. Now they are effectively well behind the curve with headline inflation at 7% and a very hot economy; we haven't seen a situation similar to this since the mid 80's.

There will be increased volatility with large falls and significant rallies for a large part of the year. It is however likely that the downs will be more than the ups. Maybe even much more so.

As a team we have been too early on moving to a risk off positioning, but the facts that have unfolded have increased our conviction. We believe that investors would be best served by reducing their exposure to risk assets until the central bank tightening is reflected in asset prices. Our view would be to find asset managers or assets classes that are prepared to take significant risk off the table at this juncture.

REZCO AND GREY RHINOS

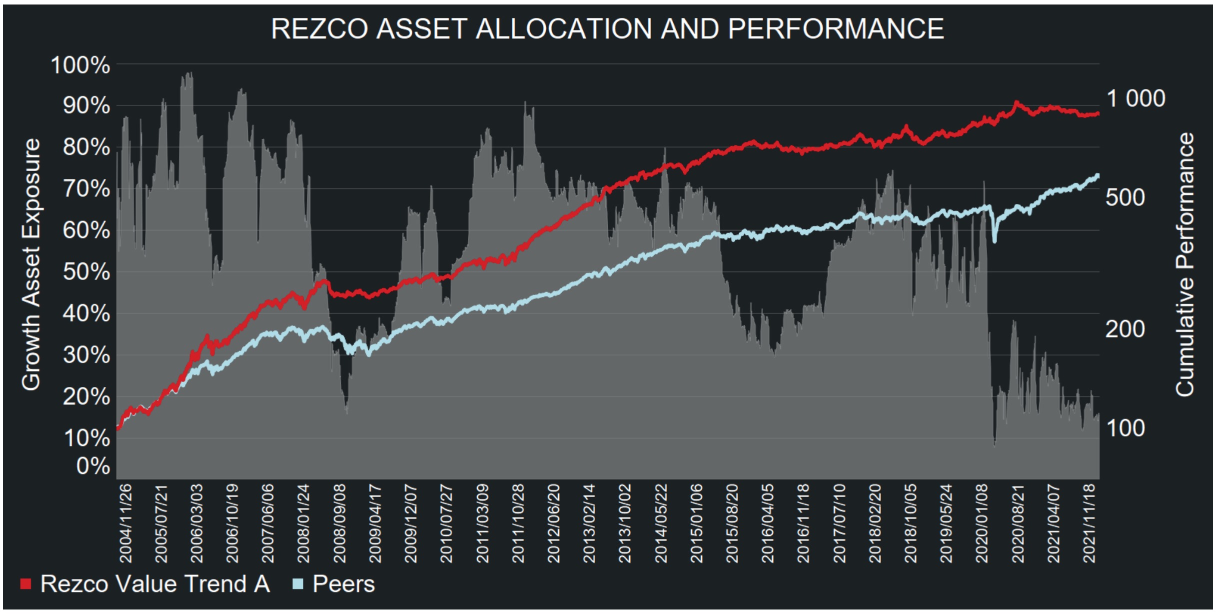
Clients will remember from our 2020 presentations regarding why we went risk off before the Corona Crash, that our risk framework includes looking out for Grey Rhinos. This is why we exited the market before the Global Financial Crisis and the Corona Crash.

A **grey rhino** is a "highly probable, high impact yet neglected threat … **grey rhinos** are not random surprises, but occur after a series of warnings and visible evidence".

The combination of very expensive markets, inflation at 35 year highs, negative real interest rates and the Fed about to start on Quantitative Tightening, are in our opinion a Grey Rhino. It may all resolve with a soft landing where central banks carefully navigate slowing down the economy through tightening, but without disruption or a recession. The threat, however, of significant drawdowns is substantial and should not be ignored as some theoretical problem that may apply only to the USA. Inflation is a global problem - the price and supply of goods are globally interconnected. Germany has just printed 25% producer price inflation, the highest since 1949.

IS REZCO ALWAYS BEARISH?

The graph below shows the Rezco Value Trend allocation to risk assets since inception. At times we are fully invested, but when the risk / reward equation moves to where we feel that we are not being paid for the risks our clients are facing, we are prepared to be uncomfortable and be risk off. Over time this has helped our clients avoid large drawdowns and achieve returns well in excess of our peers.



Rob Spanjaard
CEO & CIO