overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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GLOBAL

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Taking profit in mineral resources.

As the spectre of stagflation looms, global investors are scrambling to raise cash in their portfolios. OAM has been gradually de-risking clients' portfolios for several months. We are probably already two-thirds of the way through the global equity "bear" market, but there are still good selling opportunities. These are opportunities to raise cash, to be redeployed in a few months' time at lower prices.

Mineral resources provide a selling opportunity and opportunity to raise cash. Research firm BCA has plotted dollar-based raw material prices over 200 years. Prices are 2 standard deviations above the long-term trend. Historically, commodity bull markets end when prices reach this threshold.

Some have argued that commodities are in a new "super-cycle" as occurred from 2000-2011. However, the demand is simply not there. At that time, China's economic growth rate was in the double figures, culminating in astounding growth of 15%. China is crucial to the outlook as it accounts for a massive 50% of global mineral resource consumption. Its economy is flat-lining due to Covid lockdowns and a broken residential property market. China will be lucky to achieve 2% GDP growth in 2022. According to BCA, "Land sales, which make up about 40% of local government revenues, have dried up. This will hinder local governments' ability to finance infrastructure projects." On the CSI 300 Shanghai & Shenzhen stock market, mining resource stocks have plummeted. It is only a matter of time before world commodity stocks follow suit. Besides China, global manufacturing purchasing managers' indices are rolling over, indicating a drop in demand for mining resources across the rest of the world.

Investor demand has been a significant factor behind the bull market in metals prices. Investors have flocked due to negative real interest rates and massive liquidity expansion. Metals are also seen as an inflation hedge. However, the outlook is becoming rapidly less supportive. Global liquidity has already started shrinking and real interest rates are turning positive. Metals do not pay an income yield, which matters little when real interest rates are negative but the opportunity cost of holding metals will rise in line with higher interest rates. Metals offer some protection against inflation but only on the premise that demand is rising, not when global demand is falling, as suggested by China's bleak outlook, contracting global manufacturing purchasing managers' indices, and shrinking global trade volumes.

Some research analysts maintain that metals are in a super-cycle, but by far the majority believe they are in grave danger of significant collapse, a risk heightened by their lofty valuations and significant outperformance versus financial markets. As the forthcoming global liquidity crunch gathers momentum, cash hungry investors will gravitate to profit making investments as a source of dry powder.

The S&P 500 index and MSCI World index have dropped year-to-date by 17.15% and 16.38%. By contrast, the CRB Commodity index has gained by 44.32%, although enhanced by oil and agricultural commodity prices. The IMF Commodity Metals Price index has gained YTD by 10.27%, a rare phenomenon in today's market, and ripe for profit taking. The index is up by 107% over 2 years. OAM's Global Growth portfolios have benefited from holding BlackRock World Mining Trust plc, which has rallied by 18.8% YTD (in £), providing an excellent exit opportunity.

LOCAL

Gielie Fourie

Inflation and Interest Rates.

INTRODUCTION: The inflation rate for April 2022, announced on Wednesday last week, came in at 5.9%, unchanged from March. The next day the Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) lifted the repo rate by 50 basis points (bps) from 4.25% to 4.75%. The prime interest rate increased from 7.75% to 8.25%. The vote to lift the repo rate was split 4 – 1. Four members of the MPC voted in favour of a hike of 50 bps (they are called "Hawks"), while one member (a "Dove") voted for a rise of only 25 bps. While the inflation rate is backward looking, interest rates are forward looking. The SARB looks forward – its forecasts for inflation rates are 5.9% for 2022, 5.0% for 2023 and 4.7% for 2024. These forecasted inflation rates, not the current inflation rate, are used in the bank's Quarterly Projection Model (QPM) to determine the repo rate.

INFLATION DRIVERS: The Governor of the SARB, Lesetja Kganyago, said the decision to raise the repo rate was based on two factors that will drive the inflation rate higher in the coming months – the new Covid-19 outbreak and the sustained invasion of Ukraine by Russia. The SARB expects the war to persist for the rest of the year. The war has impaired the production and trade of a wide variety of energy, oil, food, and other commodities and will continue to do so for some time. It will dramatically worsen economic conditions for most emerging countries.

NEGATIVE REAL REPO RATES: The SARB's target range for inflation is 3% - 6%. To avoid negative real repo rates, the repo rate should be higher than the inflation rate. Despite the repo rate being raised to 4.75%, it is still lower than the current inflation rate of 5.9%. The effect is that we have a negative real repo rate of 1.15%. Negative rates are inflationary – one of the dangers is that they devalue our currency, the rand. This may be the reason why four members of the MPC were rather hawkish in raising the repo rate by 50 bps - the steepest increase since 2016. A hike of this magnitude was an important milestone in the process of rate normalisation. To move the real repo rate into positive territory we can expect more rate hikes.

INFLATION TARGET: The SARB expects the inflation rate to breach the target range of 3% - 6% in the second quarter of this year. This breach will primarily be driven by higher food, beverage, electricity, and fuel prices. The lapse of the temporary R1.50 per litre fuel levy relief will add to the pain. In addition, consumers will also be hit with higher interest rates. They will have to pay more on their bonds, monthly premiums on vehicles, taxi fares and even monthly house rentals. Real incomes will drop. Runaway inflation can lead to a recession. Consumers are in for tough times. Price increases could have a spill-over effect on increased wage demands, social demands, and strike actions by labour unions. Economic policies need to be fine-tuned to avoid this.

ECONOMIC RECOVERY: Last year saw the ongoing recovery of the South African economy from the pandemic - the economy expanded by 4.9% in 2021. The economy is expected to grow by 1.7% in 2022, revised down from the 2.0% target set in March. This is due to a combination of factors, including the flooding in Kwa-Zulu Natal and the continued electricity supply constraints. The economy is expected to expand by 1.9% in both 2023 and 2024. We need to grow faster than this. A bright spot is that Kganyago expects the commodity price basket to rise by 9.5% for the year (up from 8.0%). As a result, the current account surplus is expected to reach 2.1% of GDP this year.

CONCLUSION: Kganyago said he expects tourism, hospitality, and the construction industry to benefit from an expanding economy. Listed companies that can benefit are hotel groups like City Lodge, Sun International, Tsogo Sun and HCI, restaurant groups like Spur and Famous Brands, and construction companies like Raubex and WBHO. With the increase in the repo rate and the prime interest rate, companies to avoid are those with too much debt on their balance sheets. Raubex is a successful construction company with no debt and a strong balance sheet. It would be an ideal candidate to invest in. If you need advice, contact one of our consultants.