OVERBERG MARKET REPORT

Tuesday 14 June 2022

GLOBAL

Nick Downing

Making money in falling markets.

Nassim Taleb developed the now famous "black swan theory" to explain "the disproportionate role of high-profile, hard-to-predict, and rare events that are beyond the realm of normal expectations". These events are extreme outliers and have a severe impact. Interestingly, according to Taleb, the Covid pandemic was not a black swan event, as it was expected with a high level of certainty that a global pandemic would eventually take place. The Covid pandemic was instead, a "gray rhino", a term introduced by Michele Wucker, in her book "The Gray Rhino: How to recognise and act on the obvious dangers we ignore." Unlike black swans, gray rhinos are highly probably, high impact, yet neglected threats.

Investment portfolios need to protect against black swans and gray rhinos. Taleb's advice is not to attempt to predict events which are unpredictable, but to build robustness against potential negative events. It could be argued that surging inflation, rising interest rates and quantitative tightening are not gray rhinos as the threats have not been neglected, but the label is still relevant, to the extent that these risks have not yet been amply discounted in bond, credit and equity markets.

BH Macro Limited, listed on the London Stock Exchange in 2007, is the only way for investors to access the award-winning Brevan Howard master fund, one of the world's leading global macro absolute return investment vehicles. BH Macro provides protection against market disruption. The managers use a black swan approach to investing, rewarding investors in the event of rising volatility in financial markets and providing a solid counterbalance to any portfolio. The managers limit losses by buying rather than underwriting option structures, which tend to be far out of the money and therefore very cheap. Gains can be impressive during heightened volatility. When the market environment is not suitable, losses are limited to the price of the "cheap" out of the money options, providing investors with little downside risk.

The track record is exceptional, producing an annualised net asset value (NAV) per share return of 9.33% (GBP) since its listing in 2007. Since then, positive monthly returns have been produced in 17 of the 20 worst months for the S&P 500 index. The strongest gains tend to be when markets are under stress. During the Global Financial Crisis in 2008 and 2009, BH Macro returned 23.25% and 18.0%, and then 12.34% during the European sovereign debt crisis in 2011. As markets corrected in 2018 due to rising US interest rates and quantitative tightening, BH Macro gained by 12.43%, and when Covid struck in 2020, investors were rewarded with a 28.09% return. In the year to end May, BH Macro has already increased its NAV per share by 14.34%. By contrast the MSCI All Country World Index has dropped by 17.91%. Bond markets, the traditional counterweight in balanced portfolios, have not fared much better. The iShares International Treasury Bond ETF has lost 17.86% year-to-date.

During years when there is little volatility, for instance the period from 2012 to 2017, returns have been pedestrian, ranging from a loss of 4.35% to a gain of 5.79%. However, the managers have extended the range of asset classes they trade, to generate more exciting returns in low volatility years. This entails peripheral exposure to equity, credit, commodity and digital assets.

The main strategies remain interest rate and foreign exchange markets, which this year have generated 95% of returns. The rate book is positioned to make money from rising US Treasury bonds, providing investors with protection from inflation and interest rates, the biggest threats today. There is currently 6x leverage to movement in the US 10-year Treasury bond yield and 4x leverage to rises in the US 2-year Treasury yield. BH Macro forms a cornerstone and proven risk diversifier in our clients' portfolios. Its share price and its NAV do not always move in synch and like other closed-end investment companies, there is always the possibility that the share could trade at a widening discount to NAV. Investors should therefore be careful when investing privately and rather consult one of our wealth managers.

LOCAL

Gielie Fourie

First quarter GDP figures.

INTRODUCTION: After two years, GDP returns to pre-pandemic levels. This is very good news. South African gross domestic product (GDP) expanded by 1.9% quarter-on-quarter in the first quarter of 2022 (Q1 2022), representing a second consecutive quarter of upward growth. The size of the economy is now at pre-pandemic levels, with real GDP (R1.59 trillion), slightly higher than what it was before the COVID-19 pandemic. GDP is calculated from data gathered from ten separate industries. The ten industries are divided into three sectors: the primary sector, the secondary sector, and the tertiary sector. Growth was widespread as only two industries (mining and construction) recorded negative growth. We look at the three sectors and the ten industries.

THE PRIMARY SECTOR WAS DOWN 0.4%: (1) Mining was down 1.1%. This decline was dominated by iron ore, gold and PGMs (platinum group metals). Electricity loadshedding and logistical challenges (ports/railway) are weighing on this sector, in which real GDP reverted to 0.2% below its pre-pandemic real GDP level. Further volume expansions may be more challenging considering the aforementioned constraints. While the sector's real GDP is close to its pre-pandemic level, it is still notably below preceding peak levels. (2) Agriculture was up 0.8%. Increased production for horticulture products was the key contributor to the expansion in the agricultural sector in Q1 2022. This was despite earlier concerns about disruptions from excessive rainfall in many areas and the impact of the Russia-Ukraine war (given the importance of Russia for select agricultural exports from SA).

THE SECONDARY SECTOR WAS UP 3.7%: (3) Manufacturing was up 4.9%. This was a very strong bounce amid quite extensive loadshedding, even if 2022 loadshedding has, more than usual, been biased towards times after typical office hours and as such should be somewhat less disruptive. Stats SA attributes the growth to the petroleum and chemicals, food and beverages, and iron ore and steel industries. By Q1 2022, this sector has recovered to just 1% below its pre-pandemic (Q1 2020) GDP level. (4) Utilities output was up 2.0%. Stats SA reported higher consumption of water as well as electricity. It is only 0.8% below its pre-pandemic (Q1 2020) level of real GDP. The sector is likely to contract in Q2 2022, given the worsening of loadshedding so far. (5) Construction was down -0.7%. Construction saw its fourth consecutive quarter of contraction, with underwhelming results reported for residential buildings and construction works. This was unexpected given anecdotal evidence of a recovery in construction activity. What has happened to government's infrastructure program?

THE TERTIARY SECTOR WAS UP 1.8%: (6) Trade, catering and accommodation were up 3.1%, supported by a rise in economic activity in wholesale, retail, motor trade and catering and accommodation. (7) Transport and communication were up 1.8%, related in particular to land transport and communication services. (8) Finance and business services were up 1.7%. Stats SA attributed this sector's expansion to insurance and pension funding, auxiliary activities, real estate activities and business services. (9) Personal services were up 1.1%. Stats SA noted increased economic activity for community and other producers. This is still the non-agricultural sector that has performed best since the start of the pandemic, with real (seasonally adjusted) GDP by Q1 2022 nearly 8% higher than in Q1 2020 (prior to the pandemic). (10) Government was up 1.4%: This expansion was attributed to increased employment in national government, which presumably reflects the appointment of participants in the various temporary (and often part-time) government employment programmes.

BOTTOM LINE: The net effect was a GDP growth of 1.9%. This growth is one of the reasons why our unemployment rate has dropped marginally from 35.3% in Q4 2021 to 34.5 in Q1 2022. Growth creates jobs. We forecast South Africa's economy will grow by 2% this year, with domestic demand and household spending, rather than global demand (exports), to be the main drivers. We foresee a boost from production in the industries of domestic trade, tourism, and manufacturing, as the economy returns to normality and consumer demand picks up. At Overberg we look forward to the day when all ten industries can report strong growth. This country has so much potential.