overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

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US inflation data provide cause for celebration

Global equity markets have rallied over the past month, pushed higher by signals from the world's major central banks that they may slow down the pace of interest rate hikes. There is a lag between interest rate hikes and their impact on economic activity. At its last policy meeting the Federal Reserve lifted the fed funds rate by a further 75 basis points but in the press release said: "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

The Fed would have been heartened by the US consumer price index (CPI) data released last week. Financial markets were ebullient. Better than expected inflation figures suggest a slowdown in the pace of rate hikes and a lower terminal level for the fed funds rate is on the cards. Less punitive interest rates increase the chance that the economy could skirt recession and perform a much-desired soft landing.

How did the CPI figures stack up? The headline CPI rate eased back in October from 8.2% to 7.7%, although the month-on-month rate remained unchanged from the previous month at 0.4%. However, core CPI excluding food and energy prices eased from 0.6% M/M to 0.3%, pulling the annual rate down from 6.6% to 6.3%. The details in the CPI data are encouraging. Core goods prices fell 0.4% M/M. The increase in core services prices eased from 0.8% M/M to 0.5%. Rent prices, which comprise 40% of the core CPI basket, remained strongly inflationary but if these are excluded core CPI would have dropped in October by 0.1% M/M.

Closer analysis of rent prices is critical. They are one of the biggest culprits in today's inflation shock. Macro Strategy Partnership quotes some interesting research from Zero Hedge. It says that CPI data for rents is heavily delayed, looking at the actual rental market 6-9 months in arrears. Actual monthly data from Apartment List shows rent prices dropped by a record 0.7% in October marking the second straight monthly decline. Rents are still up year-on-year by 5.9% but down sharply from 18% a year ago amid rising vacancy rates. The latest monthly declines are widespread across the US, showing up in 89 of the largest 100 cities. "CPI is using a lagged measure, which it suggests will start turning negative in a couple of months' time when it catches up with the real time data." A similar lagged anomaly exists in the heavily weighted health insurance prices, which for the first time in October showed a strongly negative reading as more current data began to show through.

The latest employment report also gives cause for optimism. Although payrolls increased by a solid 261,000 in October, the unemployment rate increased from 3.5% to 3.7% indicating a cooling in wage pressure. Wages are often cited as posing the biggest risk to high inflation becoming entrenched. Zero Hedge again: It points out that while the official payroll increase was 261,000 the Household survey showed a 328,000 decline. The divergence in the two data sources began in April and now stands at 2.3 million payrolls, signalling perhaps that wage pressure may ease over coming months. Amazon this morning announced its intention to shed 10,000 jobs, just days after Meta announced plans for large scale layoffs.

Capital Economics forecasts inflation will drop sharply in 2023 due mainly to declines in commodity prices and more favourable statistical base effects. Core goods inflation will also fall back with easing supply chain disruptions, fewer shortages, and lower shipping costs. The research company expects long-term bonds to fall sharply next year, and for the fed funds rate to peak at 4.50-4.75%, which is only 75 basis points above current levels. It says inflation should drop by enough for the Fed to start cutting rates before the end of 2023. This sounds very promising for equity markets. However, Capital Economics also forecasts a recession and a fall in company earnings which will pull equity markets lower, at least until the middle of next year. The S&P 500 index is forecast to drop from its current level of 3900 to 3200, before recovering.

Another independent research company MRB Partners, which correctly anticipated the severity of the inflation shock in 2020 long before it materialised, has a different view. MRB believes equity markets should do well over the near term due to a combination of easing inflation pressures, a softening in US dollar strength and a pause in the bond yield advance, while economies, especially in the US and Europe will remain more resilient than generally expected. However, inflation is likely to be stickier than generally accepted, leading to a resumption of the cyclical bond yield advance and more central bank monetary tightening. Under this analysis, the S&P 500 index may firm considerably in the context of resilient economic activity and continued earnings growth until the realisation dawns that inflation is still a problem.

Neither of the scenarios are especially compelling for investors, but near-term inflation relief provides cause for celebration in the run-up to the festive season, which in any event is seasonally a good time for stock markets. There is a window of opportunity to make key long-term portfolio changes, on the buying side initially, and as the year-end rally reaches maturity, on the sell-side, before market sentiment shifts from the retreating inflation threat to the rising threat of company earnings disappointments.

Table: US Consumer Prices

	All Items		Excl Energy & Food		Core Goods	Core Services
	%m/m	%y/y	%m/m	%y/y	%m/m	%m/m
Aug	0.1	8.3	0.6	6.3	0.5	0.6
Sep	0.4	8.2	0.6	6.6	0	0.8
Oct	**0.4**	**7.7**	**0.3**	**6.3**	**-0.4**	**0.5**

Source: BLS

Local Report

Gielie Fourie

Energy and battery commodities

INTRODUCTION: South Africa is a commodity rich country. Our mines are big job creators and through the taxes they pay, they are big contributors to our fiscus. Any increased taxes paid by mines when commodity prices rise, has nothing to do with an improvement in the domestic economy (Hugo Pienaar of the Bureau for Economic Research in Stellenbosch). These tax revenue windfalls have concealed and lessened our economic woes for many years. Unfortunately, mines have limited lifespans. Our mines and commodities will not keep the country going forever. Taxes paid by our mines should be invested to build new industries that will improve our economy, create jobs, and generate strong new streams of income.

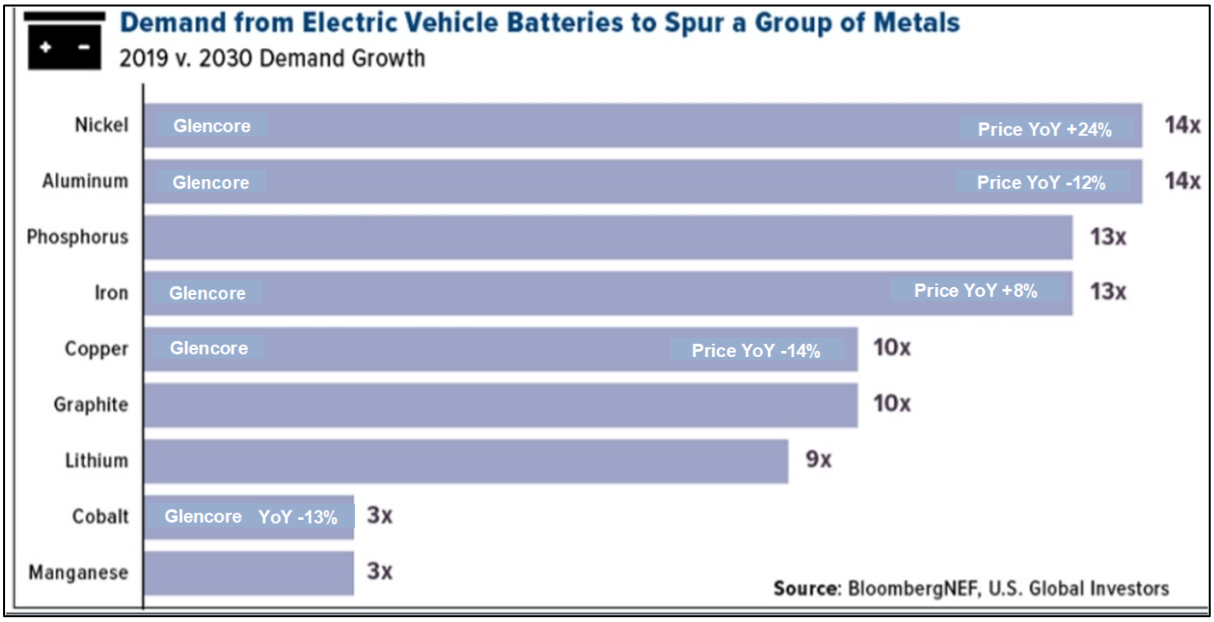
Commodity prices have experienced a strong run up to June 2022. Year-on-Year (YoY) growth figures were more than 50% according to the S&P GSCI (Goldman Sachs Commodity Index). Since June, the strong run unfortunately lost momentum. The GCSI index has dropped to 10.04% YoY. The index reached its peak on 8 March 2022 when it reached 822.3 points. It now stands at 637.36 points, a drop of 22.5% over seven months. Over ten years the index is down 0.20%. A long-term investment in commodities is risky. Commodity prices have undergone several cycles over the past 50 years. What would be the best commodities to invest in to shield you from cycles?

It is instructive to look at the performance of individual commodities. The recent commodity bull run was not synchronised across all commodities. Energy and battery commodities have performed well over the last year. YoY Brent oil is up 120%, uranium 25%, coal 62% and lithium 190%. Non-energy and non-battery commodities have performed poorly. YoY platinum, palladium, rhodium, and iron ore are all down. If you invested in non-diversified (single product) energy commodities like oil (Sasol) or coal (Thungela) a year ago you would have done extremely well. Oil and coal get a lot of bad press because they are major polluters, but they will still be around for some time. Investing in a diversified mining company with a strong portfolio of commodities used in both energy and battery technology is a clever strategy to shield you from commodity cycles.

GLENCORE: If you want to invest in energy and battery commodities, Glencore is an attractive option. It ticks all the right boxes. Ivan Glasenberg (a South African) built Glencore in just 20 years to the fourth largest mining company in the world with a market capitalisation of R1.3 trillion (£64 billion or $75 billion). Glencore is a big producer of copper, cobalt and nickel, metals set for a demand boom during the energy transition away from oil and coal. Glencore has a forward price earnings (PE) ratio of 4x and a dividend yield of 4%. Long-term debt is R38 billion, which is acceptable for a big global company. Return on equity (ROE) is 50%+. The price to book (PB) ratio is 1.9x. The current share price is R103.00. Over the past year its price is up 36%. It reported impressive 1H 2022 results with revenues increasing by 40% YoY. Glencore is not expensive. Although it does not produce batteries, the word "battery" appears 15 times in its 2021 annual report.

ELON MUSK: In June 2020, it was reported that Tesla Motors partnered with Glencore for the future supply of cobalt in their lithium-ion batteries. Glencore is the world's top producer of cobalt. On 31 October 2022, the Financial Times (FT) reported that "Elon Musk considered taking a stake in Glencore and held talks with the miner and commodities trader. Tesla discussed buying 10% to 20%

of Glencore last year (2021) and continued negotiations in March this year, when the Swiss firm's CEO Gary Nagle (a South African) visited the Tesla's factory in Fremont, California." Glencore's portfolio mix stands out from its peers, offering a leading position in key battery metals. The graphic below illustrates the projected growth in demand for battery commodities from electric vehicle manufacturers. Glencore produces five of those commodities. In addition, Glencore also produces energy products like oil and coal.



FRAUD: On May 24, Glencore Energy UK Limited indicated in court that it would plead guilty to five counts of bribery and two counts of failure to prevent bribery. Glencore stood accused of paying over US$53 million of bribes between 2011 and 2016 to officials in Africa to "secure access to oil and make illicit profit." The UK Serious Fraud Office (SFO) found that over US$25 million in bribes were paid in Cameroon, Equatorial Guinea, Ivory Coast, Nigeria, and South Sudan. Two weeks ago, it was fined £280 million ($320 million). Glencore faces continued investigations from the Office of the Attorney General of Switzerland and the Dutch Public Prosecution Service. These issues occurred under the watch of the previous CEO, Ivan Glasenberg. Investors are hoping that the new CEO, Gary Nagle, 46, will be able to draw a line under the regulatory issues.

The graphic above illustrates that Glencore has a guaranteed demand for its commodities. This demand and its impressive portfolio of commodities serves as a moat protecting it against commodity cycles. Glencore's involvement in fraud is a red flag. Glencore is headquartered in Switzerland. However, it seems that the fraud was limited to the UK operations. The new CEO, Gary Nagle, should get rid of the bad apples that caused the reputational damage.

BOTTOM LINE: Even if Elon Musk does not invest in Glencore, there is no reason you should not. In September 2022 JPMorgan Cazenove analyst in London, Dominic O'Kane, maintained an overweight rating on Glencore. He raised his price target to 690 pence from 640 pence. The current price is 502 pence, indicating a potential upside of 37.5%. Interested in investing? Contact one of our consultants. They will take the sting out of investing.

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