

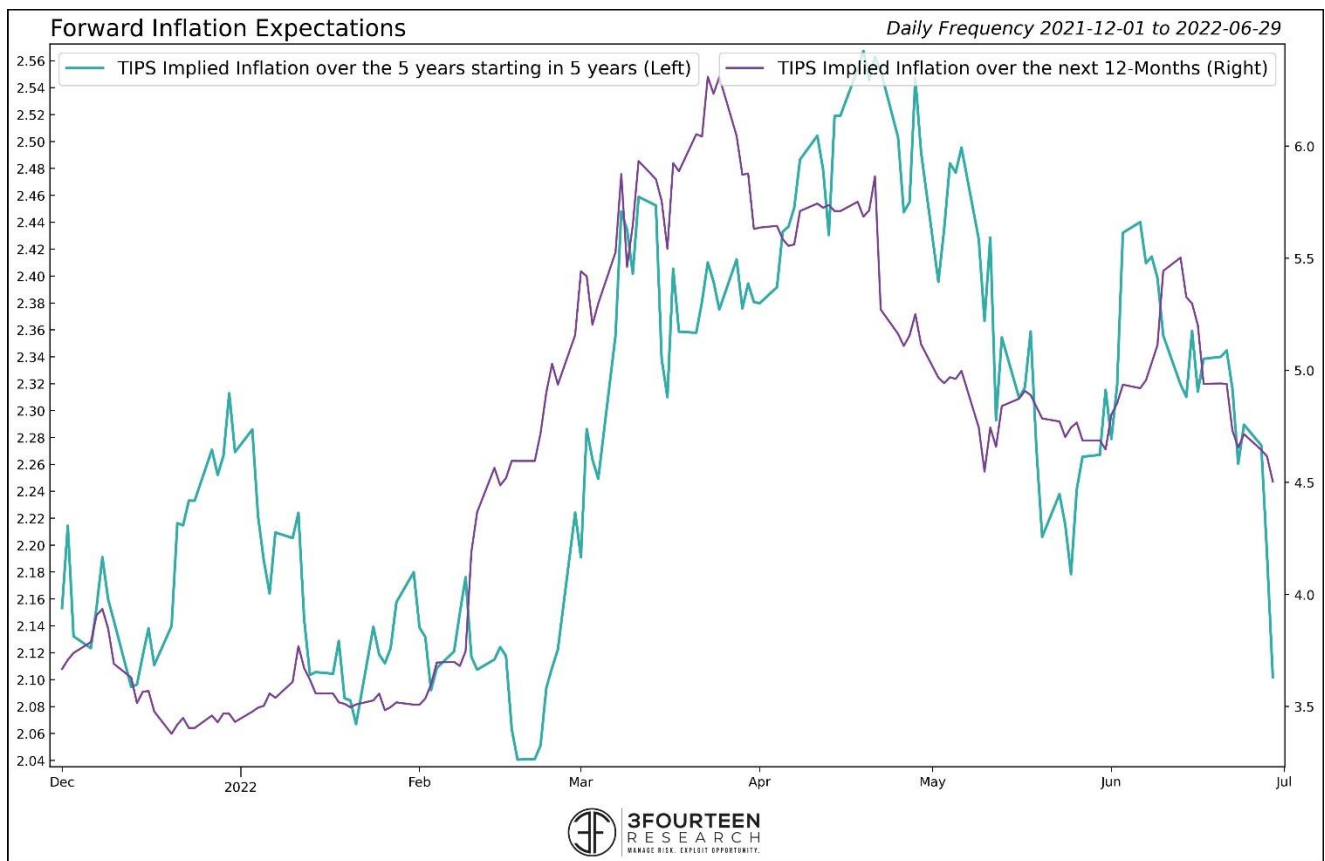
Newsletter: Second Quarter 2022

World markets have experienced the proverbial ‘blood on the streets’. During the first half of 2022, the MSCI World All-Share Index lost 21.2% in Dollar terms, while the JSE lost 8.3% in Rand terms. This market pullback is quite unusual because even traditional ‘safe havens’ suffered capital losses. The US 10-year government bond, for example, generated 8% capital losses during the first half of the year — and at the end of July 2022, even gold measured negative price movements year to date. There were, of course, much greater losses elsewhere. The crypto market lost \$2 trillion. All of a sudden the Nasdaq Index constitutes many stocks that have fallen 60% or more from their highs. We have also tripped a few landmines (think Russian stocks), but solid portfolio construction limited our losses.

During the first half of 2022, the Capicraft Global Creator fund lost only 5.2% in Dollar terms. Thus far in 2022, most of our local portfolios have delivered positive returns. Our local ‘special situations’ strategy is up 11% in absolute terms (more about this particular strategy in our next newsletter). Outperforming world indices by about 16% over a period of six months is exceptional, even if the returns are negative in absolute terms. However, I must again emphasize that such outperformance is not necessarily sustainable. Perhaps this performance gap will close somewhat in the near future. In fact, to some extent it has already happened. By the end of April 2022, our Global Creator fund was up 13% for the year (in absolute terms), outperforming world indices by about 22% at that time. Since then, however, two forces have negatively impacted us:

1. Our portfolios began participating in general sell-offs amid a looming recession; and
2. Our thematic “land, gold, and raw materials” investment strategy is experiencing drawdowns because the narrative surrounding inflation has peaked.

This change in the narrative happened suddenly. After waking up to the fact that high inflation may not be transitory, the US Federal Reserve (Fed) is now determined to fight inflation. The Fed acted by raising interest rates by 1.5% and has also promised to soon increase rates by another 1.5%. Such sharp interest rate hikes usually lead to recessions, but there is no guarantee that the Fed will break the back of inflation. Still, this change in the narrative is what the market is currently pricing in. Consider the inflation expectations of the US bond market which is implying that long-term inflation will turn back to the Fed's target of 2%.

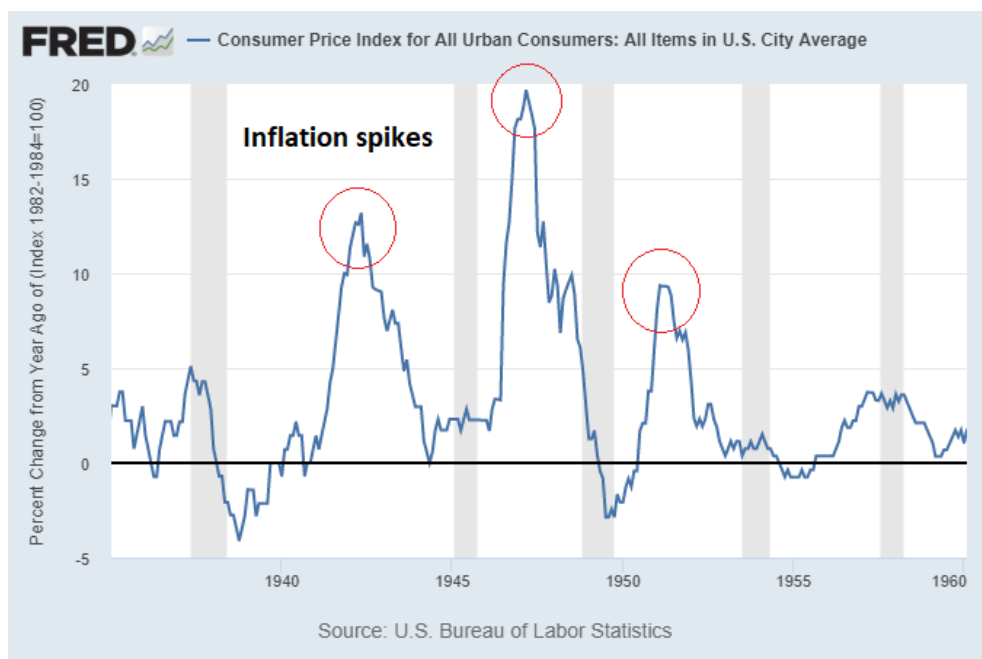


Recently, short term (i.e over the next 12 months) inflation expectations likewise fell significantly, to 4.5%, despite May inflation numbers registering 8.6%. US consumers are still expecting inflation at 6.6%. Moreover, it is not only food and energy prices that are rising. Prices from a broad spectrum of goods and services are rising. To confirm that inflation is now deeply ingrained and broad-based, consider the price of a personal service that is ubiquitous yet localized and can neither be imported nor be regulated, namely that of a haircut:

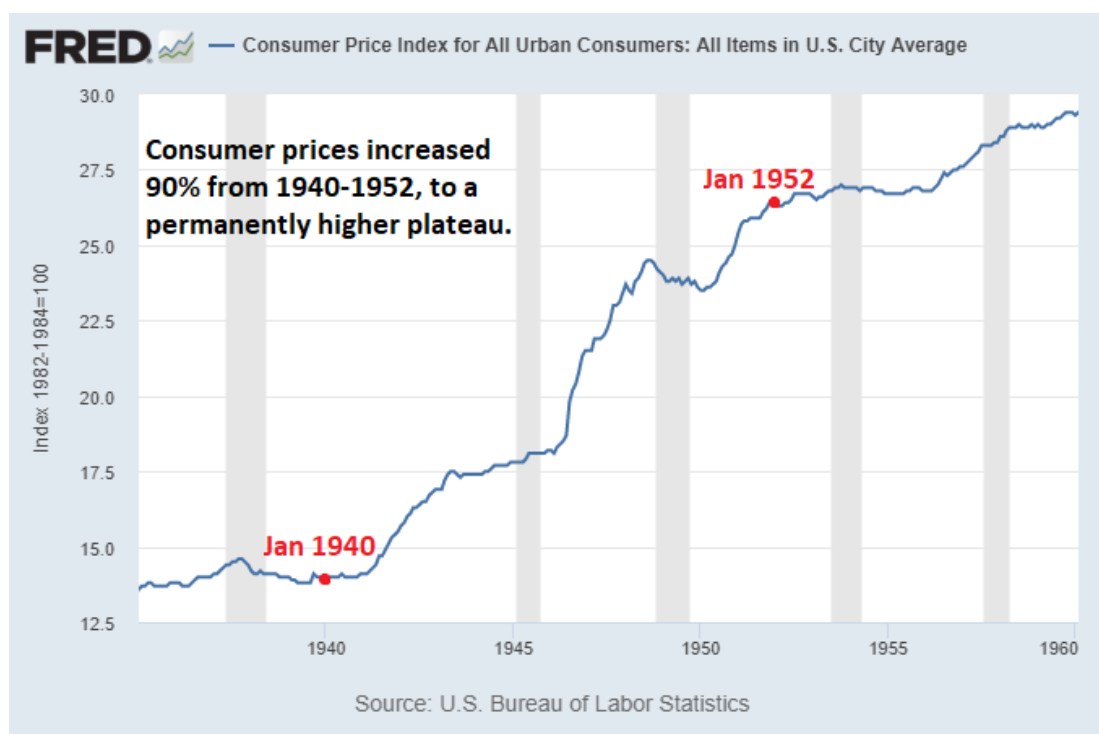


“Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair” – Sam Ewing

As a recession starts to bite, it hurts demand for various goods and services. Assuming that supply is constant, inflation should slow down. We will not be surprised if inflation peaks in the short term. In fact, our thesis and our portfolio positioning considered this all along. Where we differ from the market is the long-term inflation picture. Our thesis is that of an inflation **regime**, perhaps similar to the 1940's (but without the post-war productivity boom).



During the 1940's (and likewise the 1970's), inflation 'peaked' several times only to fall back, but raced back once demand in the economy recovered. Still, fluctuating year-on-year inflation rates ended up hiding a steady yet sustained rise in price levels. From 1940 to 1952, price levels rose by a total of 90%, reaching a permanently higher plateau. *The market is simply not positioned for such an inflation **regime**.*



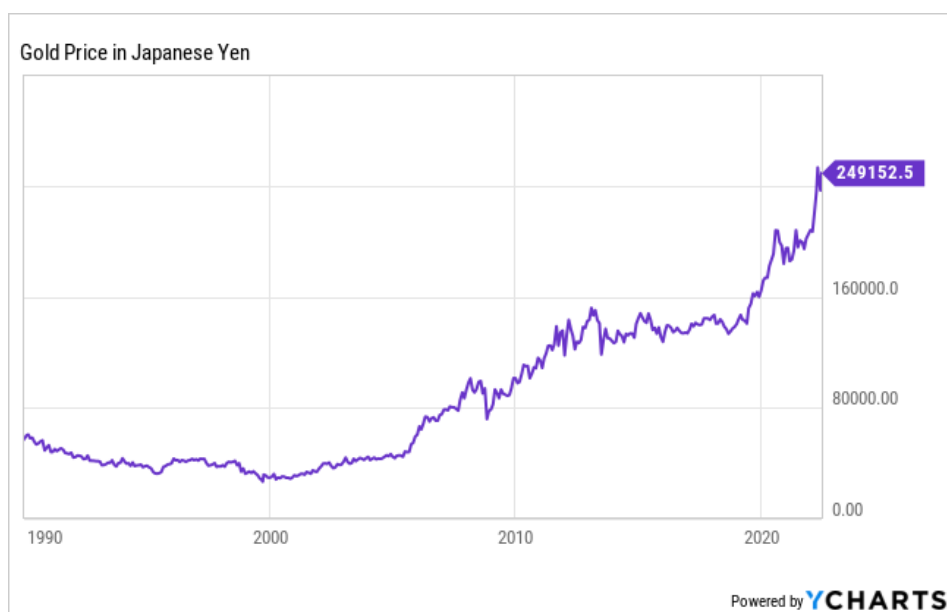
It is theoretically possible for central bankers to stop inflation dead in its tracks. However, monetary policy is quite a blunt instrument. Central banks cannot produce oil, food or ammunition. They can, however, reduce general price levels by forcing a balance between supply and demand. But if there are supply problems in sectors that have relatively inelastic demand, central banks will have to destroy the economy before they can succeed in lowering inflation. There are many reasons why the Fed's ability and willingness to go that far is quite limited.

- The Fed has a dual mandate that includes employment levels.
- Today, total debt to GDP level is 370% compared to 160% when Paul Volcker implemented the above strategy in the late 1970's and early 1980's.
- The US government has large budget deficits that will have to be refinanced at higher interest rate levels.
- The Fed can hide behind numerous geopolitical excuses.
- Western political economies are not ready for such a fight. No political party will survive it.
- A too strong dollar creates all kinds of balance of payments problems in the rest of the world that must service loans in Dollar. It could therefore undermine the entire global monetary order.
- The US economy is hyperfinancialized. Assets and liabilities are too large relative to the real economy. Financial market falls significantly effect the real economy. The 21% fall in US markets during the first half of 2022 has already resulted in a 46% decline in wealth as a percentage of GDP. This in turn has a major effect on tax collections which puts the fiscus under further pressure.

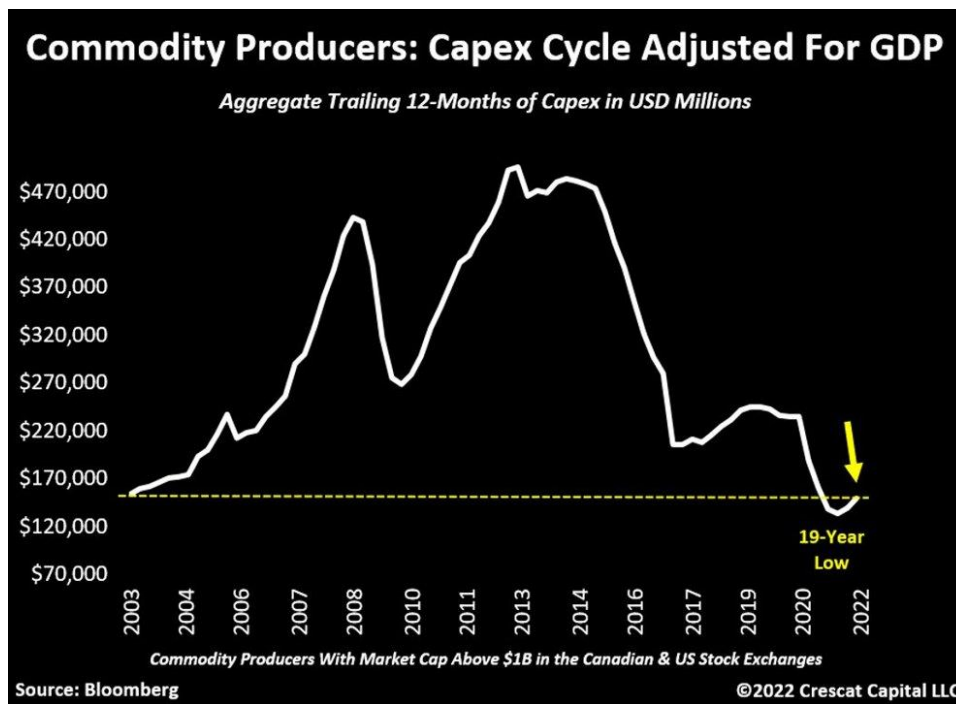


When considering the Fed's choices, watch out for a false dichotomy. One choice is for a depression (as discussed above). The second is for hyperinflation, a scenario where the Fed loses control over inflation. It is clear that the Fed wants to remove the latter risk from the playing field. As a result, many relieved investors have recently begun selling inflation hedge assets. But their muscle memory dates back to a previous regime of low inflation, low growth, and low interest rates, resulting in a portfolio dominated by government bonds and technology stocks. A similar scenario developed in the 1980's when the inflation regime of the 1970's broke down. It took five years before the market finally valued assets in line with the new growth regime of the 1980's and 1990's. Fast forward to today. We think there is a middle ground between hyperinflation and depression, namely stagflation. Central bankers are going to fight inflation, but they are never going to do enough to inflict the death knell to the economy. This means further financial repression and interest rates remaining below inflation.

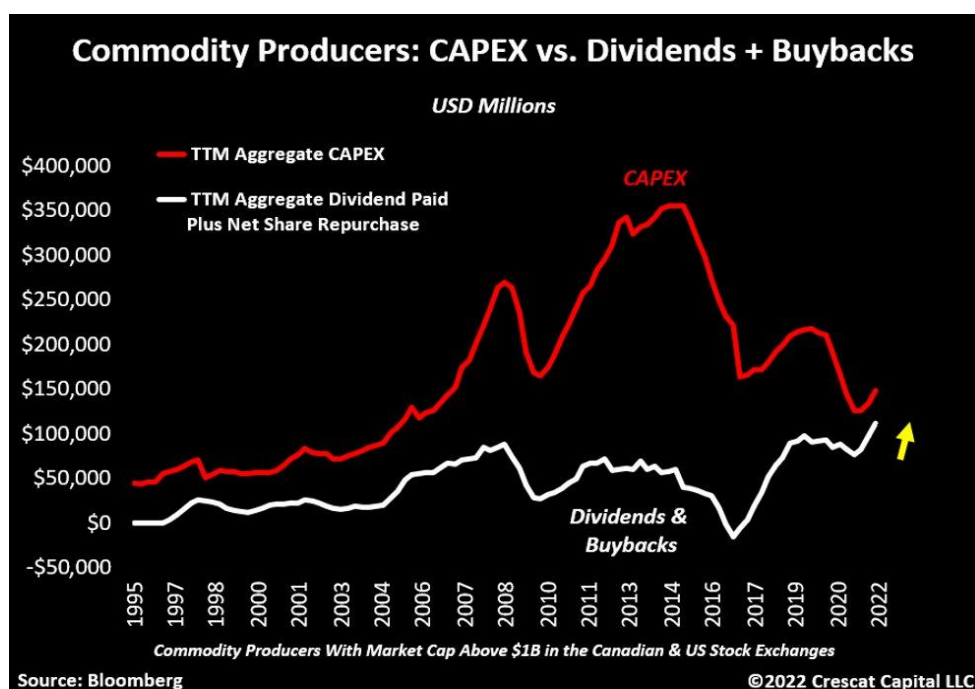
Perhaps the European Central Bank and the Bank of Japan can give us a glimpse of such a future. The former must buy weaker European countries' government bonds to avoid the disintegration of the EU. The latter's (Japan) government owes 240% of GDP and yet its 10 year government bonds are pegged at 0.25%. Since 2020, and relative to the Dollar, the Euro has lost 15% and the Yen 32% of its value. If you want to hedge against the possibility that the Fed will also be painted into such a corner, consider the chart of gold in terms of the Yen:



In previous newsletters, I elaborated on why we think the world is in a new inflation regime. Perhaps it is necessary to emphasize again that our thesis is not based on stronger demand, but on a beleaguered supply side. Covid has exposed the fragility of many supply chains around the world. Lockdowns destroyed capacity. Capital expenditure in some of the 'old' economy industries – natural resources especially — has dried up since 2015 (when the last resources bear market occurred).



Most market participants focus on the business cycle to deliver above average investment returns. However, it is very difficult to predict the business cycle. At Capicraft, we focus on the capital cycle. Sustained high levels of capital flows into a sector lead to returns on capital that fall below the cost of capital. The reverse is true for sustained underspending of capital in a sector, suggesting higher future returns on capital. Sentiment in financial markets can increase the potential of these opportunities. Regarding natural resources, what makes the current environment particularly attractive is the capital discipline that companies in this sector have shown even as it generated strong cash flows. This means that the cycle will continue longer than usual, liabilities will disappear from balance sheets, and some of these companies will also buy back their shares at attractive prices (all the while paying dividends which increase our cash position at a portfolio level).



I suspect a difficult decade lies ahead, especially for developed markets. The “Great Deleveraging” has begun. This is going to take some time. Economic growth can help but, as we are now learning the hard way, monetary and even fiscal policies can only do so much. What is missing is a productivity boost. This is where legislative policy and the rule of law play a significant role. The problem is that Western legislative policy is currently being driven by ideologically-motivated politicians who do not understand how the real world works. The result is lower productivity and stagnation. These days the policy framework of certain developed countries increasingly mirror that of some backwater countries. The big difference is probably still the rule of law, but even that is at stake these days. We constantly think about these challenges and are positioning our portfolios for a volatile investment environment. We do not base our hopes on returning to a past that once was — and also not on leaders who are bereft of the present.



A new home for Capicraft



We are excited to announce that Capicraft kicks off the third quarter at a sleek new office building. Our physical address has thus changed to: *Fintech Campus, 81 Botterklapper Street, The Willows, Pretoria.*

If you are in the area, please feel free to drop by for a cup of coffee. You are also most welcome to make an appointment at any time to discuss your portfolio in-depth. We look forward to the exciting season ahead

for Capicraft. Further, watch out for our new internet site that we will soon be rolling out. We believe this site will better present the character and improved service model of Capicraft.

Capicraft welcomes Jaco Scholtz



It is with pride and gratitude that we welcome Jaco Scholtz to the Capicraft team. Jaco is an investment expert with 25 years' experience. He is a chartered accountant (SA) and holds the CFA charter. Jaco has worked at Gensec Bank, Gryphon Asset Management and Rand Merchant Bank, often serving as a hedge fund manager. Jaco is now part of Capicraft's investment committee and will henceforth fill the role of research and investment strategist. Welcome Jaco! We trust you will enjoy sailing on the ship with us.

Your Investment Partner,

Drikus Combrinck