

Newsletter: Fourth Quarter 2022

Introduction

2022 was a year for the record books. I'm not necessarily talking about the S&P500 index which ended the year down by 20%. I'm not referring to the Nasdaq index which fell 33% during 2022. I'm also not bringing up the Western world's 40-year inflation highs or mentioning crypto market crashes. I'm talking about the sovereign bond market that broke records in 2022.

The global government bond index fell 17.1% in 2022, the worst performance since 1788! If equity markets suffer, government bonds usually do very well — a safe haven in the midst of poor economic conditions. This is why the investment industry created balanced funds that typically hold 60% in stocks and 40% in government bonds. In our previous newsletters, however, we warned that continuing to hold such funds is dangerously naive. In 2022, such a "60/40" portfolio lost 17.6% in US dollar terms, the worst return since 1937.

The Johannesburg Stock Exchange ('JSE') generated a return of 3.5% in Rand terms during 2022. Amidst weak global markets, resources were one of the few sectors where investors could hide (so to speak) — and we have plenty of resource companies on the JSE. Also, emerging markets generally performed better because valuations started from a lower point and interest rates from a higher level. The Rand weakened by 6.8% against the US dollar, naturally serving as a shock absorber for portfolios denominated in Rand. In 2022, the average South African balanced fund returned a mere 0.12% in Rand terms.

Capicraft's portfolios were much better positioned. During 2022, our local balanced mandates grew by more than 8% in Rand terms — a good performance. The Capicraft Global Creator fund, which invests mainly abroad, fell by only 0.4% in US dollar terms in 2022. This is about 18.9% better than the MSCI World Index of all shares — a brilliant performance during a difficult year.

Consensus outlook for 2023

When stock markets experience a difficult year, usually it is followed by a strong year thereafter — except in two cases. The 1974 selloff followed the losses of 1973. There were also three consecutive lean years from 2000 to 2002. These two instances show some similarities with market conditions today. In the early 2000s, the technology bubble was deflating. We continue to believe that technology stocks are overpriced today and that their profit margins are unsustainably high. This is in contrast to analysts' profit forecasts for 2023: the consensus expects rising profits. In the 1970's, the combined effect of inflation, energy shocks, and higher interest rates plunged the US economy into a recession.

After the sharp increases in inflation and interest rates we witnessed in 2022, today's consensus view is that a recession is likely, inflation is slowing down rapidly, and a so-called 'Fed pivot' (a reversal in their interest rate policy) is just around the corner. Given these views, the market is already discounting that interest rates will fall during the second half of 2023. Equity markets started 2023 on the front foot. The market is hoping for lower interest rates based on lower inflation numbers recently reported. In particular, prices of durable goods (such as cars) have been falling.

Now that the post-covid shopping boom is over and supply chain issues are less pronounced, many merchant are overstocked and they need to reduce their inventory.

During the first half of 2023, base effects will likely assist in lower inflation numbers being reported. Year-on-year inflation numbers may well be lower relative to high inflation increases witnessed during the first half of 2022. Recently, energy prices fell in most parts of the world. The above is arguably the consensus outlook for 2023, but what is Capicraft's view?

Capicraft's long-term thesis

Capicraft has been arguing for some time that inflation will fall, but we disagree with the market's view that inflation will remain low. We agree that just like the inflationary periods of the 40's and 70's, policy makers are not going to allow inflation to simply run away. Even during Weimar Germany's hyperinflation of the 1920's, there were periods when the monetary taps were tightened to reduce inflation, so much so that deflation manifested itself at brief intervals. During the aforementioned periods, secular inflationary forces, however, finally got the upper hand again and policy makers could merely try to manage the situation (control was of course lost in Weimar Germany). Briefly put, our long-term inflation thesis is based upon the following structural issues:

- Ageing and smaller workforces in the major economies of the world;
- Geopolitical shifts;
- High levels of public debt;
- Fiscal policy dominating monetary policy;
- A greater focus on the political economy in the West; and
- Underinvestment in natural resources.

The last point deals with the capital cycle of under and over-investment. Underinvestment in natural resources is currently quite pronounced due to two phenomena:

1. 'Fossil inflation', i.e., underinvestment in fossil fuels due to carbon targets and the green movement.
2. 'Green inflation', i.e., investment needed to electrify vehicles and generate renewable energy.

The stark reality is that the 'greening' of the economy can be VERY inflationary and will require even more fossil fuels.

The other 'pivot'

There is another reversal or 'pivot' that could, in the short term, upend the narrative of lower inflation. The Chinese economy is open for business again after the CCP appears to have changed their strict covid policy. Domestic flights per day have increased sharply from 3000 in November 2022 to 11500 at the time of writing. During the three years of covid restrictions, the piggy bank of Chinese consumers grew from RMB9.5 trillion to about RMB15.5 trillion. Chinese policymakers are also trying to stabilize the real estate sector as mortgage rates were recently cut by 1.5%. I don't think new skyscrapers are going to rise all of a sudden, but we've seen this re-opening movie before. Chinese consumers will go on a shopping spree — just as the world's largest workforce will get covid for the first time. That doesn't sound very deflationary to me.

Perhaps a recession will not manifest itself in the West as soon as the consensus view holds. Demand from China will support European exports; US consumers still have fat wallets. The effect of higher interest rates also typically takes longer to work itself through the economy. This is especially so in the US where most mortgages are pegged at very low interest rates. Nevertheless, debt of US corporations and debt of the US government will slowly but surely be refinanced at higher interest rates. Could a delayed (but bigger) recession materialise in 2024/25?

In this cycle, interest rates may still move higher — and stay higher for longer. 1974 may come to haunt markets in 2023. In my view, it is not good advice to invest based on the short-term consensus of a 'Fed pivot'. 5-year inflation-linked US government bonds are currently pricing in just 2.2% inflation. The market is simply not positioned for a second move of higher inflation over the medium term.

Our positioning

At the beginning of 2023, Capicraft is positioned as follows:

- Fairly defensive;
- Cautious about interest rate sensitive sectors;
- Government bonds from developed countries are still too expensive for us;
- We still don't hold any of the technology giants;
- Land, gold and raw materials (also known as *real* assets) are core holdings in our portfolios;
- Increasingly prefer selected emerging markets over developed markets;
- Focus on micro trends over macro trends; and
- Buy assets in individual or special situation events where investment success (or not) has little to do with the macro economy.

Our portfolio positioning and long-term thesis should not be confused with a forecast. To predict is to place certainty on a single or narrow outcome. A well-constructed investment portfolio requires much more humility. Instead, we weigh up different possible scenarios against what the market is pricing in. It may sound complex but is actually quite simple (and yet, very difficult to implement):

1. We seek assets where expectations priced in by the market are too low — this means if we are wrong, the damage is limited.
2. We also build portfolios where assets are not only uncorrelated with each other, but also don't expect much from each other — this means if one asset falls, other assets in the portfolio can still perform well.

Predicting a single year's return is not exactly productive. Our short-term expectations are quite open. What we do expect is that our strategy will yield better than expected returns over the long term.

Your Investment Partner,

Drikus Combrinck