

Capicraft Newsletter: Third Quarter 2024

At the end of August, the Capicraft Global Creator, our offshore fund, celebrated its third birthday. The first calendar year, 2022, was challenging. The Russo-Ukrainian War broke out, US inflation rates hit 40-year highs and financial markets suffered. The S&P500 lost about 20%, the Nasdaq 33% and even US government bonds lost 13%. The Global Creator was only 0.4% lower (in US Dollar terms) thanks to our well-refined portfolio composition and our view that there is an economic regime change underway in the global economy.

In 2023 the Global Creator added 15% and year to date we are 5.6% stronger. Although the Global Creator has underperformed this year (so far) by a few percentage points compared to its fund classification grouping, we are still well ahead over the full 37 months since inception. The Global Creator is up a total of 26% in Dollar terms (53% in Rand terms) versus an average of 4.6% for the fund group. A still short track record, but one we definitely want to build on.

The stronger Rand, however meant that local investors did not enjoy the returns of the Global Creator during this quarter. Fortunately, there was enough action in the local market to make up for it. The Compounder, our special situations strategy, which consists only of local instruments, added 18% for the quarter and is about 55% stronger over the last 12 months. This strategy's 3-year performance record stands at a total of 120%, about 30% per year. It is thanks to this strategy, and other local assets, that our portfolios ended the quarter at new highs.

We have written for some time about the opportunity that exists in the local markets. An almost perfect storm prevailed until recently. Rising interest rates and load shedding were among 2023's main features. Add to this the controversial and destructive legislation proposed, voted for and signed by the ruling party. Besides, the election still laid ahead. Lastly and less well known was Regulation 28 of the Pension Funds Act which was amended on 23 February 2022. According to it, pension funds' permitted foreign allocation moved up from 30% to 45%. Hundreds of billions moved out of local assets as a result. Valuations on the JSE have been taken to levels that represent total hopelessness. Not much had to go right to earn good returns.

This is also indeed what happened. A far-left government was avoided and at the time of writing, South Africa has already been without load shedding for 200 days. The improvement at Eskom is real and sustainable, but the Government of National Unity (GNE) is on shaky ground and coalition politics is a messy business. Nevertheless, the current cabinet instils much more confidence than the alternative and new destructive legislation will struggle to be published in the state gazette. There is also more room for civil society to organize in the current environment and thus offer further counterbalances and alternatives to the state.

The next driving force for the local markets has less to do with local events. During September the Federal Reserve (Fed) in the USA lowered interest rates by 50 basis points and paved the way for further reductions. This is despite the US inflation rate still hovering above 2% y/y, with core inflation closer to 4%. There may be a few weaker CPI prints ahead because weaker housing data (a third of the CPI index) has a delayed impact on the index. Nevertheless, the Fed was more concerned about the weaker employment figure than about their inflation target. As we (and others) have written before - **the 2% inflation target was first a ceiling, and now it is a floor.**

However, the US economy is not very interest rate sensitive - not in the short term. Almost all mortgages are fixed-rate mortgages and the business sector's debt is dominated by fixed-rate corporate bonds. It is even less sensitive during this cycle because the above-mentioned players have down their debt to record low interest rates after Covid. This, together with enormous fiscal spending, was a tremendous injection for the US economy and that is why we experienced "American economic exceptionalism" again in the last 2 years. However, with rates pegged at 3-4% lower than current interest rates, the interest rate cuts ahead will have a limited effect on the US economy.

However, this is negative for the US Dollar. Interest rate differentials are narrowing, and, at the same time, it is more attractive to park funds elsewhere in the world. Also, the banking systems of the rest of the world, especially emerging markets, are built on variable interest rates. So not only does the Fed give other central banks room to cut interest rates, but those economies are much more sensitive to lower interest rates. A weaker Dollar also improves the purchasing power of the consumer in the rest of the world. Should the Fed continue with further interest rate cuts, it will disproportionately benefit emerging markets.

We have already seen that other countries, most notably China, announced interest rate cuts - or injections of another kind - after the Fed made the first move. These economies also have greater propensity to consume, especially on goods rather than services. So, demand for commodities should pick up.

After more than a decade of "American exceptionalism" (except maybe for 2022), US financial assets have become very sought after. Real assets (such as commodities) and emerging markets make up a very small portion of investment portfolios. Many commodities are very cheap (energy, soft commodities) and most emerging markets are dirt cheap (except India and Indonesia), in contrast, the valuations of the S&P500 are extremely expensive. There may be an extended period of US underperformance ahead and we are positioned accordingly.

It's no secret that the Global Creator is exposed to real assets. We have further added to our emerging markets exposure. This also includes a small exposure to Chinese "mainland" stocks which after a decent run is still pricing in a Chinese depression. South Africa will also experience lower interest rates, better economic growth and portfolio inflows in this environment. The "local" shares on the JSE, especially the larger shares, have already priced in the moderate political climate and we are finding less deeply discounted bargains than a few months ago. We have also started to selectively take profits. However, there are still plenty of returns ahead if growth and lower interest rates do materialize.

So, one eye on the global bigger picture.

The other on local political developments.

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