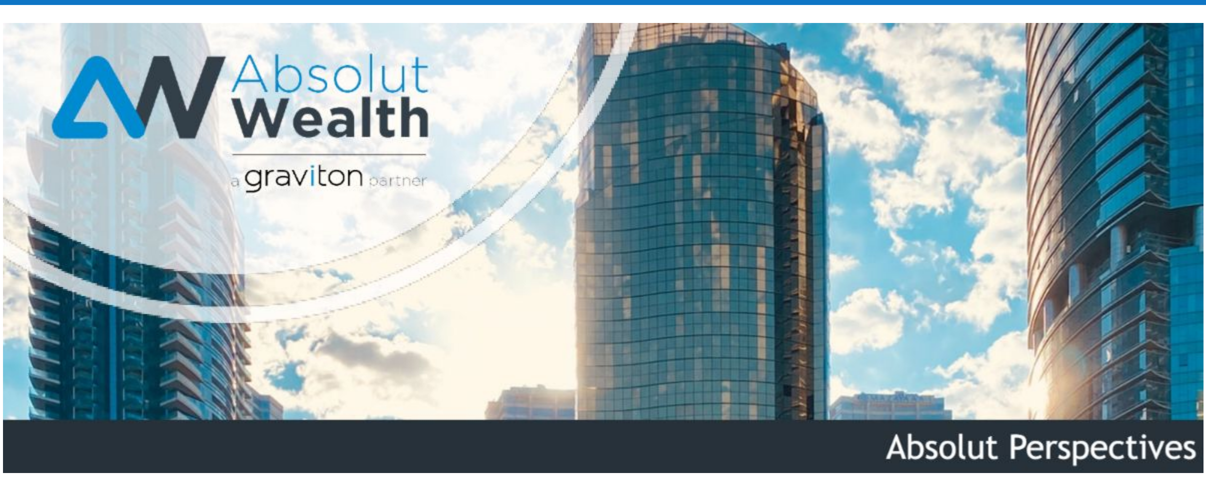


# Prevailing Sanity in Global Markets

Richard Harris | Jan 2022

Happy New Year to our readers. We wish you all a prosperous and healthy 2022.

We spent the better part of 2021 banging the drum of the "exuberant market" narrative, and for good reason.

Global Markets (with a few exceptions) staged phenomenal moves to the upside as Central Banks and Governments created one of the most accommodative environments ever seen for economic growth, in an effort to negate the effects of the COVID-19 Pandemic.

This policy accommodation flooded the market with excess liquidity and led to many stocks and indexes rising to levels far beyond logic from a valuation perspective. We showed a few graphs over the year highlighting this, but one to mention was in our "April 2021" Newsletter where we showed the graph of US non-profitable technology that had risen 400% in the space of 12 months.

We saw many "bubbles" emerging as a result of the forces mentioned above and although our calls may have been somewhat premature, sanity seems to be prevailing and we have seen indexes such as non-profitable tech, renewable energy, and other long duration assets come off significantly from their recent highs, some as much as 60%.

**The below graph shows 5-year performance of the NASDAQ 100 (red), the ARK Innovation ETF (green), iShares Global Green Energy ETF (dark blue), and Bitcoin (light blue).**

Over the last few weeks, major Developed Market Indices such as the S&P 500 and the NASDAQ 100 (US Technology) have also awoken to inherent macroeconomic headwinds such as rising interest rates and the reduction of stimulus (tapering), and find themselves on the backfoot in 2022 with year-to-date returns of -8% and -13% respectively.

Let's discuss some of the headwinds mentioned above (most apply to the United States, which now makes up more than 60% of the world's market capitalisation of stocks and bonds):

**1. The Federal Reserve (US Central Bank) started reducing its bond buying program**, which, since the start of the pandemic, provided the economy with $120Bn every month.

**2. The Federal Reserve has made it clear that there will be interest rate hikes in 2022.**
Most analysts now predict as many as 4 rate hikes of 0.25% in 2022.

**3. Corporate Taxes are likely to rise in order to assist the US Balance Sheet.**
For over a decade, the US has been very accommodative toward companies that operate in its borders, allowing them to achieve the growth that we have seen since 2010. An increase in corporate taxes will start affecting the super profits that they have been able to achieve up until now.

**4. Geopolitics.**
Rising tensions between Russia and Ukraine, and China and Taiwan will undoubtedly cause market volatility should either Russia or China choose to act on their neighbours.

Based on the inevitability of the above factors, we have been defensively positioned across our portfolios for the better part of a year and although this may have limited our upside potential to a degree, it has provided us with an excellent platform to deploy funds as Equity Markets normalise and pockets of value start to show themselves as a result.

**+** We have had significant exposure to Gold and Silver directly and through respective companies. These exposures offer promising upside potential in an inflationary environment and are generally asset classes that investors move to in times of market uncertainty.

**+** We have emphasized allocations to defensive industries such as healthcare and high dividend paying consumer staple stocks, which have outperformed growth sectors in the past few months.

**+** We have also had significant exposure to hard currencies over the past 18 months as a hedge to local volatility that we have all become accustomed to, whether it be political or purely on SA's economic strength and its longevity.

**+** We have been patient and deployed capital to Asian Technology companies at decent valuation levels and believe that China and certain other Emerging Market economies may be benefactors of US outflows as funds look to invest in environments with more favourable macroeconomic tailwinds.

The question that investors now face is the aggression with which Central Banks are going to raise rates over the next year and how global economies will handle such measures, especially with the amount of leverage (debt) created over the last decade. We have not seen a prolonged rate hike environment in the US in the past 30 years, and when the Federal Reserve tried to do so in 2013 and 2018, Global Markets sold off aggressively. The only difference now, is that Global inflation has proved to be non-transitory and Central Banks are at a point where they are forced to pursue tightening measures in an effort to control said inflation. It is not a matter of '*if*', but rather '*when*'.

## Industries that are starting to normalise, with exciting future growth prospects

As mentioned before, many forward-thinking, technology industries (with strong disruptive future prospects but little to show on company financial statements) have sold off aggressively since March last year. They are, however, still trading above pre-COVID levels, and we need to be cognizant that there may be more downside to these companies and industries as they find more stable and realistic valuations.

Although we have emphasized our views that new and disruptive technologies are likely to shape the path going forward in the way we live our lives and, as a result, favour those companies that are developing them, we have been mindful that valuations have been exceptionally lofty and even nonsensical over the past year.

We are now taking a hard look at some of those industries that are close to providing more favourable entry points and that meet our longer-term outlook for our clients. Although there is still likely downside to the industries mentioned below, we would like to mention a few disruptive industries that are now trading significantly off their recent highs.

### 1. Renewable Energy -

With combatting global warming becoming a necessity rather than an option, we believe that this industry has significant future tailwinds that will likely be bolstered by Governments and subsidies in the next decade and beyond.

### 2. Blockchain and Fintech -

It is likely Blockchain technology will reshape the way that transactions are processed and how the financial system operates as a whole in the coming years. Blockchain (Cryptocurrencies) are arguably the first asset class to be created in over 600 years and although still in its infancy with respect to understanding and adoption, we believe that it shows similar growth prospects to Internet companies in the late 1900s.

### 3. Cannabis -

Cannabis has a variety of use cases (over and above medicinal and recreational) and can be cultivated at a much faster pace than other natural resources that serve similar industries. Regulation and acceptance are still major obstacles to the industry, but once further adoption takes place, cannabis is likely to deliver significant upside in the years to come.

### 4. Biotechnology -

Much like Renewable Energy, Biotechnology and medical advances are more of a need than a want. Many companies are spending fortunes on R&D to improve health and medical cures that will allow better management of diseases and provide a better quality of life to all. Investment at the right prices should provide good growth prospects in an industry that is likely to only grow in the future.

### 5. Gaming / Virtual Reality -

Online Gaming has taken the world by storm in the last decade and E-sports (electronic sports) attract similar crowds to traditional sports globally. Virtual reality creates virtual worlds like the "Metaverse" in which people live and allows users to interact within a three-dimensional environment using electronic devices, such as special goggles with a screen or gloves fitted with sensors. The largest Tech companies in the world such as Facebook (now Meta) and Microsoft are prioritising the Metaverse as an area of focus.

### 6. Artificial Intelligence -

The ability of machines to carry out day-to-day jobs and activities without emotion, often at far greater speeds and efficiency than possible from human counterparts.

### 7. Electric / Autonomous Vehicles -

Vehicles that are no longer reliant on fossil fuels to operate; this extends to industrial-use vehicles. Autonomy will most likely change the way we commute and move goods and services.

## The Outlook for the South African Market and Economy

Over the past year, we have also outlined our concerns toward the local economy and those who govern it. Despite several lockdowns, the July Riots, an election and other headwinds, South Africa has remained resilient, largely due to:

- An impressive Current Account surplus (aided by the strong rise in commodity prices).
- A well-run Reserve Bank that has, for the most part, acted in the interest of South Africa and its citizens, headed by Lesetja Kganyago.
- The strength of our judicial system, especially the Constitutional court and its capability to keep law and order somewhat in check, to the best of its ability.

2022 will likely be another interesting year in South Africa. It seems that most COVID restrictions are out of the way for now, but other factors are likely to come to the forefront.

We believe that strong commodity prices will continue to aid our current account and economy in general in the short-term. However, we are interested to see the effects of rising inflation (caused by higher fuel, electricity, and commodity prices) together with almost-certain interest rate hikes (that are likely to notably affect an already strained consumer). On top of that, we have the ANC elective conference at the end of the year, which is likely to further expose the cracks of the "good" and "bad" factions of the ruling party.

It is without doubt going to be an interesting year for South Africa and the world as a whole, as global countries try to normalise and find their feet without the aid of Central Banks and other Government-related aid.

## Market Review

Global Developed Markets have had their worst start to the year in recent history with major indexes selling off between 3% and 13% in the space of a month. Notable losers were the NASDAQ (-13%), the Nikkei/Japan (-8.8%), and the S&P 500 (-8%). These moves came as Central Banks signalled their intention to reign in stimulus measures and start hiking rates in an effort to curb inflation.

Notwithstanding the aggressive selloffs mentioned above, the South African All Share Index was one of the few to gain (+1.8%) aided by strong commodity prices and global investors looking for alternatives to expensive US bond and equity markets.

Commodities continued to be well bid based on notable supply shortages and increasing demand from multiple industries. Notable gainers were Palladium (+20%), Crude Oil (+18%), Iron Ore (+9%), and Aluminium (+8%). With the exception of Oil, the strength of commodities in general, coupled with a weakening Dollar, helped the Rand firm to 1.5% in January to settle at R15.4/$.

Despite recent moves, our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios, which we look to deploy into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

***"The art of investment is the discipline of inaction in the absence of a good opportunity, but aggressive action when one is identified"*** - Li Lu