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Preparing for more uncertainty and volatility

A look back over the last two years reveals how difficult forecasting is. Even with perfect foresight of the pandemic context, one would not have been able to predict the market moves. So how should investors think about investing in an environment of ongoing uncertainty and volatility? Duncan Artus offers some insights below and in our first video update for 2022, sharing both a review of 2021 and an explanation of how the portfolios are positioned to maximise opportunity in a changing inflationary environment.

As I write this in mid-January 2022, COVID-19 is still affecting everyday life globally despite vaccine roll-outs, but the FTSE/JSE All Share Index (ALSI) is reaching new all-time highs in rand terms and the FTSE World Index is within 3% of its all-time dollar high. In contrast, the US two-year treasury bill produced its first negative return in over three decades. South Africa finished the year with a lower inflation rate than the US, yet the US 10-year bond yields 1.7% compared to the SA 10-year at 9.5%. However, the headline numbers often hide considerable differences between and within markets.

The South African equity market, as represented by the ALSI, returned 29.2% in 2021, outperforming both cash at 3.6% and inflation of 5.5%. The Capped SWIX, which many funds use as a more representative equity benchmark, returned 27.1%. Industrial shares slightly underperformed their resource and financial counterparts. Local bonds underperformed equities, with the FTSE/JSE All Bond Index delivering 8.4%. Global bonds also underperformed, with the FTSE World Government Bond Index returning 1.0% and the FTSE World Index returning 31.3% in rands, respectively. The rand weakened 8.6% against the US dollar, which was strong against most currencies.

The US equity market continued to dominate returns, with the S&P 500 outperforming the FTSE World ex US Index in dollars by 17% over 2021 and a cumulative 50% over the past three years. Most international indices are making new lows relative to the US and especially the Nasdaq. We are underweight US equities.

Performance review

Absolute performance improved due to rising asset prices, but relative performance remained muted, especially from the offshore portion of our funds. Pleasingly, the value in some of our local holdings is being recognised by others as acquirers or being realised by the companies themselves. These include Remgro, Rand Merchant Insurance (RMI), Old Mutual, AVI, Investec, Royal Bafokeng Platinum, Liberty, Woolworths, Aspen Pharmacare and Long4Life. It is hard, if not impossible, to predict when sentiment towards a company will change, but eventually assets simply get too cheap.

The Balanced Fund returned 20.3%, in line with its benchmark, after giving back some outperformance in the last quarter of 2021. The Stable Fund returned 15.1%, well ahead of its benchmark.

Within equities detractors included British American Tobacco and AB InBev, despite sound delivery by the underlying businesses. Not owning and/or being underweight Richemont and MTN respectively were missed opportunities to improve returns. Glencore was our biggest positive contributor, outperforming BHP and Anglo American as iron ore corrected from very high levels, but still benefiting from overall strong commodity prices. Other positive contributors included Woolworths and Sasol. There was also a sharp recovery in many smaller positions, including hospitality shares such as Tsogo Sun and Sun International and financials like Investec.

The Orbis Global Equity Fund gave back a considerable amount of its performance from the vaccine lows in November 2020 returning 9.1% in dollars for the year, lagging the FTSE World Index by 11.9%. The Orbis SICAV Global Balanced Fund returned 7.2% versus a 60/40 benchmark that returned 9.8%. The offshore portfolios continue to be positioned very differently from the benchmark and most of our peers.

Positioning

In last year's CIO commentary, I noted: "Central banks and governments, particularly in the developed world, have responded to the economic fallout of the pandemic with a combined fiscal and monetary policy response of almost unprecedented proportions outside of war time. In the short term this has propped up economies, but over the longer term the bill will come due – potentially in the form of higher inflation and interest rates."

This view still holds true, and inflation has indeed returned to the developed world with some of the highest numbers in decades. While inflation may turn out to be transitory, and indeed we expect the rates to fall, inflation must only be 3%-5% to back central banks into a corner and leave them with only hard choices: Put a lid on price increases to control inflation expectations and risk toppling asset markets, or let it run? Inflation always hits the poorest sections of society first and hardest. This has political consequences. I believe that higher realised inflation and interest rates are not good for the valuations of long duration growth stocks that have led markets higher for so long.

Indeed, the US market is very narrow i.e., the indices are being held up by a few big stocks, while the average stock has performed poorly. A narrow market is more associated with market tops than bottoms. We remain underweight US equities and prefer the valuations we see in Europe, the UK and Asia.

Local asset markets continue to be dominated by international trends despite the devastating riots in July, Eskom's woes, and poor performance in certain areas of our government. Local assets remain sensitive to events in China. Many of the largest shares in our market such as Naspers/Prosus, Richemont, BHP and Anglo American are heavily reliant on China whether directly, in the case of Naspers, or indirectly – as the biggest customer for Richemont's luxury goods or the commodities the miners produce. South Africa, as a mainly commodity-based economy, enjoys the second-round effects of higher commodity prices, which are important for local consumer and financial companies. These include, among others, higher tax receipts, surpluses on our current account and lower interest rates. This proved to be the case when many domestic companies produced better-than-expected results. I am not sure how our economy would have coped had the pandemic occurred during a commodity downturn.

China matters for Naspers. Tencent accounts for over 100% of its current share price. Naspers matters for the average South African fund. After years of consistent outperformance, Naspers sharply underperformed the market from mid-2020 as Tencent fell from HK$766 to HK$457. China also matters for commodity prices, specifically iron ore. The iron ore price reached US$229 per tonne during May before falling to US$84 and spot of US$128. This compares to our sustainable price, which is closer to US$80. This gap makes a difference to the free cash generation of BHP and Anglos. Our preferred mining share has been Glencore, which does not have exposure to iron ore, but does have an attractive commodity basket plus the world's largest commodity marketing business.

I believe that given the potential risks highlighted above, British American Tobacco provides a valuable hedge against a broad sell-off in Chinese-related equities, commodities and technology stocks. However, if the markets continue to trend upwards, it will most likely underperform. We continue to tilt the portfolios to protect against the increased probability of higher inflation.

The portfolios have exposure to precious metal ETFs and we increased positions in Gold Fields and AngloGold, both of which have retraced a significant proportion of their 2020 outperformance.

Balancing risk and return

Despite a strong year for equity markets and pleasing higher absolute returns, we are preparing for more uncertainty and volatility. Investing successfully involves not only looking to generate above-average returns, but also managing risk.

Locally, we can look to Turkey for a real-world example of the consequences of experimenting with radical economic theories. Turkey's starting point was an economy more than twice the size of ours in a far more geographically strategic position.

While the South African market may be trading near all-time highs when measured in rands, many shares are still well off their pre-pandemic highs – illustrating that there is value to be found. Internationally we continue to believe the disparity between and within equity markets is almost as wide as it has ever been, and that long-dated sovereign bonds are at the beginning of a multi-year bear market. South African fixed income at least offers a real rate of return.

The largest short-term risks I see are how South African assets would behave in the event of a sell-off in US equities, and how the Chinese economy will evolve as it attempts to transition to greater consumption and the deleveraging of the private sector.

The investment team is applying the same philosophy and process we have for the last 48 years in managing your hard-earned savings. As always, I encourage you to focus on your long-term goals, rather than worrying about the daily news cycle – as hard as that is these days. On behalf of the investment team, I thank you for the trust you have placed in us.

Adapted from the chief investment officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2021.

Commentary contributed by Duncan Artus, chief investment officer, Allan Gray.

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