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Client Letter

Half Year 2023

Dear Client

It is amiss of me to have waited so long to author a client letter – my last one being in December. In truth, after a year of bad news, I have been waiting for a sustained trend that would allow me to deliver a more positive report. I believe such a time has arrived. Despite knowing that the disruptive events of 2022 events would pass, and markets eventually recover, keeping this perspective is a challenge when in the middle of the storm. Whilst the rumblings of inclement weather persist, I believe it is moving away rather than towards.

The core reason for the drop in markets was the rise in interest rates. The underlying cause of this was the rise of inflation caused by the shortage in supply of essential commodities as a result of the invasion of Ukraine by Russia, as well as some delayed effects of Covid lockdowns. When interest rates rise, it causes a drop in the value of assets/investments. An investment is the purchase of expected future cash flows (dividends). If you expect to receive $100 in a year's time and current interest rates are 1%, then the present value (price) is $99. If the interest rate rises to 5%, then the present value is $96 – a drop in value of 3%. If you extend the calculation to 10 years, then the value drops from $95 to $61 - a much larger 32% decline. As equities are long term investments, with cash flows discounted for many years ahead, interest rate increases have a profound effect. Some shares are more sensitive than others, e.g. many technology companies are expected to pay little to no dividends in the near term (as most of the cash is used to develop new innovations), and therefore dividend expectations are weighted to the long term, making them more sensitive to interest rate movements. This in large part explains why their values have come down so much more. It is worth noting that bonds (considered a safer haven) are valued in the same way, and therefore also succumb to a rise in interest rates.

Whilst markets can be regarded as efficient (they quickly adjust to changed circumstances), they tend to also be very emotional in the short term. It is inevitable that interest rates will eventually settle and start declining, but the market seemed to assume the high rates are here for ever. News previously regarded as good is now considered bad. Where markets would normally welcome growth in the job market and wages, it now views this as an indication that consumer demand is too strong and will force central banks to keep interest rates high. Whilst commodity prices can still be regarded as high, they are generally quite a bit off their peaks reached last year. Also, from a pure mathematical point of view, even if prices remained at their peaks, year on year inflation would decline because this year's price compared to last year would show 0% growth, i.e. 0% inflation. In fact, because of the high base and somewhat lower commodity prices, it is possible for inflation to turn negative, i.e. deflation compared to last year. From the start of this year, there has been the realisation that inflation has for the most part peaked and would decline (as it now is), and with it the prospect of interest rates also declining. However, the skittish day

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traders are nervous of a repeat of last year's rout, causing much volatility. For the long-term investor, keep to your course, as markets are recovering and I believe still have much upside in them.

USA, Germany and Japan are up between 15% and 17% in US Dollars for the first half of 2023, and Tech shares almost 40%. These markets are only between 5% and 8% off their 2021 highs, or 12% in the case of Japan. These movements are in anticipation of lower interest rates, so I believe will jump up considerably more when rates do actually start their decline.

There are nuances to the above theme in other markets; such as India which is up by a lower 7.5%, but then didn't drop as much as others; the UK up 6%, which is struggling a bit more with high inflation; and China which has remained flat, grappling with the after effects of harsh Covid lockdown policies, political interventions in companies seen as monopolistic, and an all too close relationship with Russia and antagonism with the west. As for South Africa, our list of problems is well known, manifesting in a negative US Dollar return of 6% for the half year.

As I have for many years, I continue to favour the USA, with a weighting towards technology counters. My previous enthusiasm for China has waned and I advised early last year to lighten exposure, but it is impossible to totally avoid given its global influence. For me India is still one to hold for its massive potential, which is gradually being realised, as too numerous other Asian countries. Despite South Africa also having potential, this will not be realised under such poor macro policies and is therefore not to my mind worth considering until fundamental policy changes are made.

I have since 2008 not considered the bond market a viable investment, due to the low interest rate environment. However, with current higher rates I believe it now a good prospect for those seeking somewhat less volatility, decent interest income, and the potential bonus of capital gains when interest rates decline. Once again, I favour offshore over SA.

For those considering moving funds out of SA, I think the good upside potential from the continued market recovery will outweigh the weakened rate at which you would exchange the Rand. Should you wish to add to your portfolio, or switch if you want to adopt my line of thinking, then please let me know.

Regards

Colin

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